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IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

No. 720

ISADORE BLAU, a stockholder of Air-Way Industries, Inc., suing on behalf of himself and all other stockholders similarly situated and on behalf and in the right of Air-Way Industries, Inc.,

Petitioner,

against

EDWARD LAMB and EDWARD LAMB ENTERPRISES, INC.,

Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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TABLE OF CONTENTS

	PAGE
Opinions Below	2
Jurisdiction	2
Questions Presented for Review	2
Statutes Involved	4
The Preferred Stock Transactions	5
The Common Stock Transactions	7
Reasons Relied on For Granting the Writ	9
ARGUMENT:	
I—The Court below has decided an important question of Federal law contrary to the express statutory language and its legislative history and contrary to prior interpretative decisions	10
II—The decision by the Court below is in direct conflict with the decision rendered by the Court of Appeals for the Third Circuit	15
III—The District Court's findings were not "clearly erroneous" and the Court below, therefore, improperly reversed them	17
IV—The Court below improperly exempted from the operation of Section 16(b) the shares of Air-Way common stock which the respondent acquired from Industries	18
Conclusion	21

TABLE OF CASES

PAGE

B. T. Babbitt, Inc. v. Lachner (C. A. 2), 332 F. 2d 255 12

Blau v. Lehman (C. A. 2), 286 F. 2d 786, aff'd 368 U. S. 403 12

Booth v. Varian Associates, Inc. (C. A. 1), 334 F. 2d 1 12

Federal Security Insurance Co. v. Smith (C. A. 10), 259 F. 2d 294 18

Ferraiolo v. Newman (C. A. 6), 259 F. 2d 342 11

Gratz v. Claughton (C. A. 2), 187 F. 2d 46 .....11, 13

Heli-Coil Corporation v. Webster (C. A. 3), 352 F. 2d 156 .....10, 12, 15, 16

Park & Tilford, Inc. v. Schulte (C. A. 2), 160 F. 2d 984 .....12, 13, 20

Shaw v. Dreyfus (C. A. 2), 172 F. 2d 140 16

Smolowe v. Delendo Corp. (C. A. 2), 136 F. 2d 231 ..11, 13

United States v. Real Estate Board, 339 U. S. 485 ... 18

United States v. Yellow Cab Co., 338 U. S. 338 18

STATUTES AND RULES

8 Delaware General Corporation Law, Sects. 251, 252 6

Federal Rules of Civil Procedure, Rule 52(a) 17

Securities Exchange Act of 1934:

Sects. 3(a)(13), 3(a)(14), 15 U.S.C.A., Sects. 78c (a)(13), 78c(a)(14) 4, 7, 12, 14, 19

Sects. 16(a), 16(b), 15 U.S.C.A., Sects. 78p(a), 78p(b) 4, 7, 10, 11

Sect. 27, 15 U.S.C.A., Sect. 78aa 4

OTHER AUTHORITIES

	PAGE
H. R. Report No. 1383, 73d Cong., 2d Sess. (1934), p. 13	12
Insider Trading Under the Securities Exchange Act, by Cook and Feldman, 66 Harv. L. Rev. 385, p. 624	14
S. Report No. 792, 73d Cong., 2d Sess. (1934), pp. 7-9	12
S. Report No. 1455, 73d Cong., 2d Sess. (1934), pp. 55-68	12
Stock Exchange Practices, Hearings before the Senate Committee on Banking and Currency, 73d Cong., 1st Sess., pt. 15 (1934), pp. 6463, 6557	11

INDEX TO APPENDIX

	PAGE
Opinion	22
Statutes	58

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Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

TO THE HONORABLE, THE CHIEF JUSTICE AND ASSOCIATE JUSTICES OF THE SUPREME COURT OF THE UNITED STATES:

Your petitioner, Isadore Blau, a stockholder of Air-Way Industries, Inc. (Air-Way), acting on behalf of himself and the other stockholders of said corporation, respectfully prays that a Writ of Certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit rendered June 27, 1966 which, as amended by order dated September 9, 1966, reversed the judgment

of the United States District Court for the Southern District of New York as to all recoveries except $7,811.40 (R. A104, A173).*

Opinions Below

The opinions of the District Court (R. A24-A44) are reported in 242 F. Supp. 151. The opinions of the Court of Appeals (R. A67-A103, A171, A175), which reversed the judgment of the District Court and denied petitioner's application for a rehearing *en banc*, have not yet been reported.

Jurisdiction

The judgment of the Court of Appeals (R. A104) was entered on June 27, 1966. By orders dated September 9, 1966, respectively (R. A171-A177), the Court of Appeals denied petitioner's application for rehearing and for rehearing *en banc* although it amended its original opinion and the judgment by increasing the respondents' liability for damages by an additional sum of $5,556.38.

Jurisdiction is conferred upon this Court by 28 U.S.C., Section 1254(1).

Questions Presented for Review

1. Where an officer, director or beneficial owner of more than 10% of an issuer's listed securities purchases and then voluntarily converts his issuer's convertible equity securities within a period of less than six months, does such voluntary conversion constitute a "sale" of the convertible security within the language and meaning of Sections 3(a)(14) and 16(b) of the Securities Exchange Act of 1934, 15 U.S.C.A., Sects. 78c(a)(14) and 78p(b)?

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* References are to pages of record certified to this Court by the Clerk of the United States Court of Appeals for the Second Circuit.

2. Under Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C.A., Sect. 78p(b), does the Court have the power, specifically and exclusively delegated by Congress to the Commission alone, to exempt from the statutory operation a transaction which is embraced within the express language and intended meaning of that statute, although the Commission itself has not promulgated any rule granting such an exemption?

3. In order for an "insider's" conversion of his issuer's convertible equity security to be construed a "sale" thereof under Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C.A., Sect. 78p(b), must the issuer, or a stockholder suing on its behalf, bear the burden of proving that such conversion afforded the "insider" with some opportunity to misuse his inside information?

4. Where there was ample evidence to support the District Court's findings that the "insiders'" short-swing transactions in their issuer's securities were speculative in nature and the kind sought to be proscribed by Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C.A., Sect. 78p(b), was it proper for the Court of Appeals to reverse such findings because it preferred to draw different inferences from the facts, although the appellate court did *not* find such findings to be "clearly erroneous"?

5. Under Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C.A., Sect. 78p(b), where an "insider" acquires his listed issuer's equity securities from a publicly-owned corporation, more than a majority of whose stock is owned and controlled by him, are such acquisitions of the listed issuer's shares exempted from the operation of Section 16(b) of the Act solely because they were acquired from the corporation controlled by the insider, although the Commission has not promulgated any rule exempting the transaction from the statutory application?

Statutes Involved

Pertinent provisions of the Securities Exchange Act of 1934, Sections 3(a)(13), 3(a)(14), 16(a) and 16(b), 15 U.S.C.A., Sects. 78c(a)(13), 78c(a)(14), 78p(a) and 78p(b), pp. 235, 322, 62 cum. supp., are set forth in Appendix, *infra*, at pp. 58-59.

The action was instituted by petitioner, Blau, as a stockholder of Air-Way, pursuant to the provisions of Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C.A., Sect. 78p(b), to recover the profits realized by the respondents, Edward Lamb (Lamb) and Edward Lamb Enterprises, Inc. (Enterprises), as a result of their respective purchases and sales within less than six months of both Air-Way's listed common stock and its unlisted convertible preferred shares.

The basis for jurisdiction of the United States District Court for the Southern District of New York, where the action was instituted, is Section 27 of the Securities Exchange Act of 1934, 15 U.S.C.A., Sect. 78aa.

During all material times here involved the common shares of Air-Way, a Delaware corporation, were listed on the American Stock Exchange. The respondent, Lamb, was an officer and director of Air-way; the respondent, Enterprises, was the beneficial owner of more than 10% of Air-Way's listed securities (R. A1, A2, A4).

Enterprises was at all times the personal holding company of the respondent, Lamb, who, together with his family owned all of its outstanding shares (R. A7, A16).

Prior to June 30, 1955, the respondents, Enterprises and Lamb, together with the latter's family, *owned* approximately 90% of the outstanding stock of Lamb Industries, Inc. (Industries), although they actually *controlled* 97% of its shares. Approximately 10% of

Industries' shares were *publicly owned** (R. A129). *None* of its securities were ever listed on any national securities Exchange (R. A9).

In February 1955, as the result of a proxy fight with Air-Way's management, the respondent, Lamb, obtained control of Air-Way's Board (R. A9, A19).

The Preferred Stock Transactions

At Lamb's "suggestion", Air-Way's Board of Directors adopted a Resolution, which was submitted and approved at its annual stockholders' meeting on March 22, 1955, authorizing an increase in the number of Air-Way's common shares and authorizing the creation of 100,000 shares of $50 par value Preferred stock, but deferring the fixation of the rights and preferences of such Preferred stock to a later date. The Proxy Statement sent to Air-Way's stockholders in connection with such annual meeting stated that "the Company has no present intention to issue any of said Preferred stock." (Def. Ex. K; R. 478)

On June 9, 1955, at which time the respondent, Lamb, was in complete control of Air-Way's Board of Directors, the latter set apart 60,000 shares of such Preferred stock, designating it as a Convertible Preferred issue, and authorized, (a) its conversion at the holder's option on the basis of 3½ shares of common for each Preferred share (b) the payment of a 5% quarterly dividend thereon, and (c) one (1) vote for each Preferred share (R. A13, A14; Pl. Ex. 8; R. 52).

At the same June 9, 1955 meeting Air-Way's Board also authorized that an offer be made to the stockholders of Industries for an exchange of their shares on the basis

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* 3% of such shares were owned by 45 public stockholders, and an additional 7.24% of such stock was owned by Edward Lamb Foundation, Inc. (Foundation), an eleemosynary corporation which Lamb controlled.

of five (5) shares of Industries for each share of Air-Way Preferred (R. A10).

Such exchange offer was approved by *Industries'* stockholders the very next day, i.e., June 10, 1955, and the transaction was *fully consummated* within the next few weeks. The approval of such exchange offer by Air-Way's stockholders, however, was neither sought for nor given until March 27, 1956, *approximately nine (9) months after such exchange of stock had actually been consummated,* although such transaction materially diluted the equity interests and voting rights of Air-Way's stockholders (R. A10).*

Within the less than six month period between July 5, 1955 and September 15, 1955, the respondents exchanged all of their Industries stock for 39,849 convertible Preferred shares of Air-Way and then voluntarily converted such Preferred stock into 149,471 shares of Air-Way common having a much greater market value (R. A11, A12, A17).

Only three (3) days before the respondents' conversions of such Preferred stock, Air-Way's Board declared a 100% stock dividend on its *common* shares payable October 14, 1955; four (4) days after such conversions Air-Way's Board declared a 15 cent per share cash dividend on such split common stock payable October 24, 1955 (R. A14).

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* The affect of such exchange and subsequent conversion of the Air-Way Preferred stock actually diluted the Air-Way stockholders' equity interest by approximately 57% and constituted a *de facto* merger requiring the *prior approval* of 66⅔% of its outstanding shares. (See, 8 Delaware General Corporation Law, Sects. 251, 252.) At the time the *Industries* stockholders accepted the offer to exchange their shares, however, the Lamb interests only owned 35½% of Air-Way's stock and obviously were unable to muster the required ⅔ vote. On March 27, 1956, after the transactions had been fully consummated and the Air-Way stockholders were asked to vote on the matter, the Lamb interests owned approximately 52% of Air-Way's voting stock (R. A7, A10).

We parenthetically note that on June 30, 1955, more than ten (10) weeks *before* such 100% common stock dividend was declared by Air-Way's Board, the respondent, Enterprises, borrowed the sum of $816,850 from a New York bank and deposited with it as collateral 74,700 shares of Air-Way common. In connection with its deposit of such collateral the respondent, Enterprises, represented to the bank in writing that the number of Air-Way common shares would be doubled "upon receipt of 100% stock dividend on 10/14/55" (Pl. Ex. 19; R. 71).

The district court expressly found after trial without a jury that "the speculative nature of the (respondents') preferred stock transactions" and their opportunities for speculation and misuse of inside information in connection therewith had been clearly established. It further found that the respondents' acquisitions and voluntary conversions of the Air-Way Preferred stock within less than six months constituted "purchases" and "sales of such securities within the express language and intended meaning of Sections 3(a)(13), 3(a)(14) and 16(b) of the Securities Exchange Act of 1934, 15 U.S.C.A., Sects. 78c(a)(13), 78c(a)(14) and 78p(b), and that the respondents had realized recoverable profits from such transactions in the aggregate sum of $1,138,782.31, for which judgment was duly awarded (R. A26, A31, A33, A41, A42).

Although agreeing that respondents' *acquisitions* of the Air-Way Preferred stock constituted Section 16(b) "purchases", the Court of Appeals, nevertheless, overruled the district court's findings that their voluntary *conversions* of such preferred shares were statutory "sales", and accordingly, reversed the judgment with respect to those transactions (R. A78, A79).

The Common Stock Transactions

On June 6, 1955, the respondent, Enterprises, acquired from Industries 68,100 *common* shares of Air-Way to-

gether with $227,850 worth of other assets in exchange for 40,002 shares of Industries plus Enterprises' assumption of Industries' bank debt in the sum of $581,250 (R. A18, A19).

The district court found that such exchange constituted a Section 16(b) "purchase" by Enterprises of the 68,100 shares of Air-Way common at $10,182 per share (R. A35, A41, A42).

On October 6, 1955, the respondent, Enterprises, sold 10,500 shares of Air-Way common to Industries at $19 per share; on October 13, 1955, Enterprises sold an additional 6,500 Air-Way common shares (after the 100% stock dividend had become effective) at $9¼ per share (R. A6).

The district court matched Enterprises' "purchase" of Air-Way common on June 6, 1955 against its sales on October 6, 1955 and October 13, 1955 and found that Enterprises had realized a recoverable profit from these transactions in the sum of $153,526.50 (R. A41).

The Court of Appeals overruled such findings and reversed this part of the judgment on the theory that, since the Lamb interests controlled 97% of Industries' outstanding stock,* Enterprises' acquisition from Industries of the 68,100 Air-Way common shares allegedly was *not* a Section 16(b) "purchase" because such transaction "was at most a token change in the insider's investment position" which allegedly did not "alter the nature of his investment" nor place him in a position "where he could make any more advantageous use of inside information for speculative purposes than he could have before the transfer" (R. A97).

Although the district court awarded judgment against the respondents in the aggregate sum of $1,297,419.76

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* As we have heretofore shown, the respondents only *owned* approximately 90% of Industries' outstanding stock, although they *controlled* 97% thereof; 10% of Industries' stock was *publicly* owned.

(R. A45-A47), the Court of Appeals completely reversed such judgment except as to the sum of $2,255.02 which it found to be recoverable from the respondents in connection with certain other short-swing transactions not here material (R. A68).

By order dated July 8, 1966, the Court of Appeals granted petitioner's application extending his time to file a petition for rehearing until August 2, 1966 (R. A117-A119).

On August 1, 1966, petitioner filed his petition for a rehearing *en banc* with the Clerk of the Court of Appeals (R. A125-A152). By order dated August 3, 1966, the Court of Appeals granted leave to the Commission to file its brief as *amicus curiae* in support of the rehearing petition (R. A153). On August 8, 1966, the Commission filed its brief in support of petitioner's application for a rehearing *en banc* (R. A155-A162).

By decisions and orders dated September 9, 1966, the Court of Appeals denied the petition for rehearing, although it amended its original opinion and judgment by increasing the respondents' liability for damages by the additional sum of $5,556.38 (R. A171-A177).

Reasons Relied on For Granting the Writ

1. The Court of Appeals for the Second Circuit has decided an important question of federal law which has not, but should be settled by this Court. Its interpretation of the federal statute finds no sanction in the language of the statute itself and is in conflict with the stated Congressional purpose and legislative history which prompted its enactment.

2. The opinion by the Court of Appeals for the Second Circuit is in direct conflict with the opinion rendered by

the Court of Appeals for the Third Circuit in *Heli-Coil Corporation* v. *Webster* (C. A. 3, 1965), 352 F. 2d 156. As a result of such conflicting decisions, a condition of uncertainty and confusion has arisen with respect to the interpretation and application of Section 16(b) of the Securities Exchange Act of 1934, which can only be resolved by this Court.

3. Although the district court's findings were amply supported by the evidence and *not* "clearly erroneous", the Court of Appeals reversed such findings upon the ground that it chose to draw different inferences from the facts.

4. The decision by the Court of Appeals for the Second Circuit, exempting respondents' purchases of Air-Way common stock from Industries from the operation of Section 16(b) of the Act, finds no sanction in the language of that statute or its legislative history and purpose, and constitutes a usurpation of the function expressly delegated to the Commission alone.

ARGUMENT

I

The Court below has decided an important question of Federal law contrary to the express statutory language and its legislative history and contrary to prior interpretative decisions.

The stated purpose of Section 16(b) of the Securities Exchange Act of 1934 is "preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer." The statute imposes liability upon such "insider" for all profits realized from his purchases and sales of his issuer's equity securities within less than

six months, "irrespective of (his) intention in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months."[1]

The statutory language, as well as its legislative history, clearly demonstrate that the insider's liability was intended to be predicated solely upon an *objective* test which would require no proof that the insider actually obtained any confidential information or that he misused it for his personal benefit in effecting his short-term transaction.[2] Such considerations were deemed "entirely irrelevant"[3] upon the theory that "if only those persons were liable who could be proved to have a bargaining advantage, the execution of the statute would be so encumbered as to defeat its whole purpose."[4] Moreover, it was felt that "had Congress intended that only profits from an actual misuse of inside information should be recoverable, it would have been simple enough to say so."[5]

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[1] The relevant statutory provisions are set forth in the Appendix, *infra*, pp. 58-59.

[2] The operation of Section 16(b) was explained by Thomas G. Corcoran, the Administration's spokesman at the hearings which led to its adoption, as follows:

> "That is to prevent directors receiving benefits of short-term speculative swings on the securities of their own companies, because of inside information. The profit on such transaction under the bill would go to the corporation. You hold the director, irrespective of any intention or expectation to sell the security within 6 months after, because it would be absolutely impossible to prove the existence of such intention or expectation, and you have to have this crude rule of thumb, because you cannot undertake the burden of having to prove that the director intended, at the time he bought, to get out on a short swing." *Stock Exchange Practices, Hearings Before the Senate Committee on Banking and Currency*, 73d Cong., 1st Sess., pt. 15 (1934), pp. 6463, 6557.

[3] *Ferraiolo* v. *Newman* (C. A. 6), 259 F. 2d 342.

[4] *Gratz* v. *Claughton* (C. A. 2), 187 F. 2d 46, 50.

[5] *Smolowe* v. *Delendo Corp.* (C. A. 2), 136 F. 2d 231, 239.

The Congressional hearings antedating the enactment of Section 16(b) of the Act had disclosed that options, conversions and similar devices lent themselves quite readily to abuses involving unscrupulous short-term trading by corporate insiders.[6]

In order to close off this avenue against active insider abuse, Congress expressly *broadened* the ordinary definitions of "purchase" and "sale" to *include* within their scope "any contract to buy, purchase, or otherwise acquire", and "any contract to sell or otherwise dispose of."[7]

In most instances where an insider has voluntarily converted his issuer's convertible securities the courts have applied such statutory definitions to the transaction and construed the conversion to be a Section 16(b) "purchase" or a "sale".[8] In the case at bar, the district court adhered to the express language of the statute and its intended purpose by finding that the respondents' voluntary conversions of their Air-Way Preferred stock constituted Section 16(b) "sales" thereof.

Although the Court below acknowledged in its opinion (R. A79) that the "unambiguous legislative history" and "broad reach of Section 16(b)" and the "early judicial declarations that the section embodies an '*objective*' test of insider liability, require the unstinting application of

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[6] *Booth* v. *Varian Associates, Inc.* (C. A. 1), 334 F. 2d 1, 3-4; See, S. Rep. No. 1455, 73d Cong., 2d Sess. (1934), pp. 55-68; S. Rep. No. 792, 73d Cong., 2d Sess. (1934), pp. 7-9; H.R. Rep. No. 1383, 73d Cong., 2d Sess. (1934), p. 13.

[7] See Sections 3(a)(13) and 3(a)(14) of the Act, *infra*, p. 59.

[8] *Park & Tilford, Inc.* v. *Schulte* (C. A. 2), 160 F. 2d 984; *Blau* v. *Lehman* (C. A. 2), 286 F. 2d 786, aff'd 368 U. S. 403; *B. T. Babbitt, Inc.* v. *Lachner* (C. A. 2), 332 F. 2d 255; *Booth* v. *Varian Associates, Inc.* (C. A. 1), *supra*; *Heli-Coil Corp.* v. *Webster* (C. A. 3), 352 F. 2d 156.

this section to any exchange of shares that can be described as a 'purchase' or a 'sale'," and that "One can, as a matter of language, describe the conversion of a company's convertible preferred stock into an equivalent amount of common stock as a 'disposition' or 'sale' of one equity security (the preferred) and an 'acquisition' or 'purchase' of another (the common)" because, under such approach, the transaction could be considered "without further inquiry, the type of insider activity that Section 16(b) was designed to prevent,"—nevertheless, in reversing the district court's findings that the respondents' voluntary conversions of their Air-Way Preferred stock constituted statutory "sales", the Court of Appeals completely rejected the application of such "*objective*" test and substituted a "*subjective*" one instead. Under such a *rationale*, the respondents' conversions of their preferred stock would be construed Section 16(b) "sales" *only if* the petitioner were able to prove that the transactions had some element of unfairness, i.e., that they afforded the respondents with *some opportunity* to misuse their inside information.

We believe that such a narrow, restricted view of the statute's application is erroneous, illogical and completely repugnant to the legislative intent because the legislative history and express language of Section 16(b) clearly indicate that Congress intended to eliminate such a "subjective standard of proof requiring a showing of an actual unfair use of inside information."[*]

Although the Court below conceded (R. A80) that the language in *Park & Tilford, Inc.* v. *Schulte* (C. A. 2), *supra*, "certainly suggests that every conversion (of preferred into common stock) should be said to involve a Section 16(b) 'puchase' of the common", and that "sev-

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[*] See, *Smolowe* v. *Delendo Corp.* (C. A. 2), *supra*, at p. 236; *Gratz* v. *Claughton* (C. A. 2), *supra*, at p. 50.

eral courts have read *Park & Tilford* as standing for precisely such a rule",—the Court below, nevertheless, tried to distinguish that case by pointing out that its application *there* "dealt specifically only with whether a conversion should be considered a Section 16(b) *'purchase'* of the *common*", and *not* whether it should be considered a Section 16(b) *"sale"* of the *preferred*.

Such attempted distinction in the application of the *Park & Tilford* rule, however, is completely unsound and logically unjustified in the light of the statutory definitions which *similarly* describe the terms "purchase" and "sale" as *including* "any contract to buy, purchase, or otherwise acquire", and "any contract to sell or otherwise dispose of."[10] For it seems quite clear from such definitions that if the insider's voluntary conversions of preferred into common stock constitute statutory *"purchases"* of the *common*, such conversions must also be construed as statutory *"sales"* of the *preferred* stock.

Several authorities have stated that "a construction which did not consider the conversion (of preferred stock into common) a *sale* of the *preferred* would facilitate abuse of inside information through short-swing trading", thus permitting the insider to evade the statutory provisions of Section 16(b) of the Act.[11]

The decision of the Court below in its interpretation of Section 16(b) of the Act now "leaves this important area of the law almost ludicrously uncertain". Unless such uncertainty and confusion is settled by this Court, the administration and enforcement of the statute will be breached to such an extent that its continued existence will become meaningless.

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[10] See Sections 3(a)(13) and 3(a)(14) of the Act, *infra*, p. 59.

[11] *Insider Trading Under the Securities Exchange Act*, by Cook and Feldman, 66 Harv. L. Rev. 385, at p. 624.

II

The decision by the Court below is in direct conflict with the decision rendered by the Court of Appeals for the Third Circuit.

In holding that the respondents' voluntary conversions of Air-Way Preferred into common stock did not constitute Section 16(b) "sales" of the Preferred, the Court of Appeals for the Second Circuit laid down the rule that, in every case involving an insider's conversion of his issuer's convertible security, the test as to whether such conversion constitutes a Section 16(b) "purchase" or a "sale" must only be determined upon the basis of a "*subjective*", rather than an "objective", evaluation of the transaction itself, its attendant circumstances and its ultimate effect. Under such a "*subjective*" test the issuer, or a stockholder suing on its behalf, would be required to prove as a *sine qua non* for the statutory application, that the insider's voluntary conversion of his issuer's convertible security afforded him with some opportunity to misuse his inside information.

The recent decision by the Court of Appeals for the Third Circuit in *Heli-Coil Corp.* v. *Webster* (C. A. 3, 1965), 352 F. 2d 156, conflicts directly with the decision rendered below by the Court of Appeals for the Second Circuit.

In *Heli-Coil* the insider had purchased his issuer's convertible securities and then voluntarily converted them into common stock less than six months later. In holding that the insider's conversions constituted Section 16(b) "*sales*" of the *convertible securities*, the Court of Appeals for the Third Circuit laid down the rule that the proper test for determining whether an insider's voluntary conversions of securities constitute Section 16(b) "purchases" or "sales" must be predicated upon an "*objective*" test, rather than a "subjective" one. It further held that under such an

"*objective*" test, it was entirely immaterial and unnecessary for a determination of the issue whether or not the insider's voluntary conversion of his issuer's securities afforded him with any opportunty to misuse his inside information. The incidence of his relationship to the issuer was all that the statute required.

Although the Court below conceded in its opinion (R. A80-A81) that "Recently, however, the Third Circuit (in *Heli-Coil*) has concluded that precisely the same (*objective*) approach (followed in *Park & Tilford, Inc.* v. *Schulte, supra*) required an affirmative answer to the question whether a conversion is a Section 16(b) 'sale' of the preferred", nevertheless, the Second Circuit stated, "We do not agree" with the Third Circuit's decision, and "Certainly we are not compelled to do so by any Second Circuit precedent."[12]

The obviously conflicting views taken by the Second and Third Circuits have created a chaotic condition of confusion and uncertainty in the proper application of Section 16(b) which can only be remedied by this Court.

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[12] But see the Court's opinion in *Heli-Coil* (at p. 164), where the Third Circuit construed the test in the *Park & Tilford* case as "very largely objective", stating that it "employs the language of Sections 3(a)(13) and 3(a)(14) in the manner in which we think Congress intended it to be used and that is in *no* sense a subjective one."

In an earlier decision in *Shaw* v. *Dreyfus* (C. A. 2, 1949), 172 F. 2d 140, the Second Circuit cited the objective test of *Park & Tilford* with approval, stating (at p. 142):

> "* * * But the acquisition there under consideration (in *Park & Tilford*) was one similar to a purchase. Schulte exercised an option to convert his preferred stock into common stock. Similarly, we would hold that the Act applies as well to executed dispositions as to executory contracts to dispose, provided the disposition is similar to a sale. * * *".

III

The District Court's findings were not "clearly erroneous" and the Court below, therefore, improperly reversed them.

In laying down its "subjective" test for the statutory application involving an insider's voluntary conversion of his issuer's securities, the Court below stated that the respondents' conversions of Air-Way Preferred into common stock could only be construed Section 16(b) "sales" of the Preferred after an "initial inquiry" by the trial court has convinced it "that the transaction in question held out at least the possibility of abuse" (R. A84).

The district court made such "initial inquiry" and found "On the basis of the evidence produced at trial" that the respondents' voluntary conversions of Air-Way Preferred into common stock constituted Section 16(b) "sales" of the Preferred because they "were the kind (of transactions) sought to be proscribed by the statute" and were "rife with opportunities for speculation and misuse of inside information" (R. A30-A33). Such findings were not made lightly, but after an exhaustive study of the entire record consisting of over 2,000 pages, and after a lengthy trial during which the trial court was able to properly evaluate the "live" testimony of witnesses.

Although such findings were amply supported by the evidence and were *not* "clearly erroneous" (R. A143-A146), the Court below reversed such findings because it chose to draw different inferences from the facts.

Rule 52(a) of the Federal Rules of Civil Procedure provides, however, that "Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses."

It is an elementary proposition of law that where reasonable men may draw different inferences from the facts of a particular transaction or resolve the ambiguities differently, and where the evidence would support a conclusion either way, the appellate court may not substitute its judgment for the findings by the trial court unless "clearly erroneous."[13]

Significantly, the Court below made no determination that the district court's findings were "clearly erroneous". Accordingly, since there was evidence in the record to support the district court's findings, the reversal of such findings by the Court below was improper as a matter of law.

IV

The Court below improperly exempted from the operation of Section 16(b) the shares of Air-Way common stock which the respondent acquired from Industries.

On June 6, 1955 the respondents were in control of 97% of the stock of Industries, an Ohio Corporation, although they actually *owned* only 90% of its securities.[14] On that date, through an exchange of assets, the respondent, Enterprises, acquired from Industries 68,100 shares of Air-Way common. Less than six months later, Enterprises sold 17,000 shares of the Air-Way common stock.

The district court found that Enterprises' aforesaid acquisition of the Air-Way common stock constituted a

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[13] *United States* v. *Real Estate Board*, 339 U. S. 485, pp. 495-496; *United States* v. *Yellow Cab Co.*, 338 U. S. 338, pp. 341-342; *Federal Security Insurance Co.* v. *Smith* (C. A. 10), 259 F. 2d 294, 295.

[14] 3% of Industries' shares were owned by individual *public* stockholders; 7.24% of such shares were owned by Foundation, an *eleemosynary* corporation controlled by the respondents.

Section 16(b) "purchase" within the statutory definition of Section 3(a)(13) of the act.[15] Matching such "purchase" with Enterprises' sales of such stock less than six months later, the district court found that the respondents had realized recoverable profits from these common stock transactions of an additional sum amounting to $153,526.50.

The Court of Appeals reversed such findings and held that Enterprises' acquisitions of the Air-Way common from Industries were not Section 16(b) "purchases" because the respondents controlled 97% of Industries stock.

Although recognizing that 3% of Industries stock was owned by individual public stockholders and another 7.24% of such stock was owned by an eleemosynary Foundation of which the public was the ultimate beneficiary, the Court below held, nevertheless, that such public stock ownership of Industries was "not sufficient to affect the unity of interest between Lamb, Enterprises and Industries", and that the respondent's acquisition of Air-Way common from Industries did not put such insider in the position "where he could make any more advantageous use of inside information for speculative purposes than he could have before the transfer" (R. A97-A98).

We believe that such rationalization and conclusion is contrary to the language of Section 16(b), as well as its intended purpose, for the following reasons.

At the outset, the Court below applied a *"subjective"* test to the transaction involved by predicating its decision upon the basis as to whether or not the acquisition of the Air-Way common stock could afford the respondents with a more advantageous opportunity to misuse their inside information. But we have heretofore shown, however, that the language and legislative history of Section 16(b) re-

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[15] The term "purchase" is defined by this section "to include any contract to buy, purchase, or otherwise acquire." See Appendix, *infra*, p. 59.

quires for its application an "*objective*" test, rather than a "subjective" one. Under such "objective" test an insider's opportunity to misuse his inside information in a given short-swing transaction is entirely irrelevant.

Secondly, the purpose and effect of the decision by the Court below was to *exempt* the acquisition of the Air-Way common stock from the operation of the statute solely because the respondents controlled 97% of Industries' shares.

But *nowhere* in the statute or its legislative history does it appear that Congress intended to empower the *courts* to exempt transactions from the operation of Section 16(b). In fact, under the express language of the statute, such exemptive powers were granted *exclusively* to the Commission to whom the administration of the statute was expressly entrusted.

Since the Commission had not promulgated any rule exempting the respondent's acquisition of Air-Way common from Industries, the Court below was not entitled to usurp the Commission's function in this respect.

Furthermore, although the Court below decided to exempt the instant acquisition of stock from the statutory application because the respondents owned 97% of Industries' shares, it freely admitted that "we have been unable to formulate a bright-line rule as to how much stock control (less than 100%) is enough to invoke the rule" (R. A98).

We note in passing, however, that in *Park & Tilford, Inc.* v. *Schulte* (C. A. 2), *supra,* the Court of Appeals held that the insiders' conversions of Preferred into common stock constituted "purchases" of the common, *although the insiders owned more than 99% of the issuer's Preferred stock and approximately 92% of its common shares.*

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

Morris J. Levy,
Counsel for Petitioner,
Isadore Blau,
261 Broadway,
New York, New York 10007.

APPENDIX

Opinion.

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 202—September Term, 1965.

(Argued December 17, 1965 Decided June 27, 1966.)

Docket No. 29940

ISADORE BLAU, a stockholder of Air-Way Industries, Inc., suing on behalf of himself and all other stockholders similarly situated and on behalf and in the right of Air-Way Industries, Inc.

Plaintiff-Appellee-Appellant,

—v.—

EDWARD LAMB and EDWARD LAMB ENTERPRISES, INC.,

Defendants-Appellants-Appellees.

Before:

WATERMAN, KAUFMAN and HAYS,

Circuit Judges.

Derivative stockholder's suit instituted by Isadore Blau, a stockholder of Air-Way Industries, Inc., to recover for Air-Way certain alleged short-swing profits allegedly realized by the defendants Edward Lamb and Edward Lamb Enterprises, Inc.

Appendix.

The district court, United States District Court for the Southern District of New York, Tyler J., adjudged, in an opinion reported at 242 F. Supp. 151 (1965), that Air-Way should be awarded $206,356.45 as against Lamb and $1,091,063.31 jointly and severally against Lamb and Enterprises. The defendants appealed, seeking reversals of the awards except for $2,205.04; the plaintiff appealed, seeking modification of the awards, and for an allowance of interest on recoveries.

Judgment reversed as to all recoveries except $2,255.02, and affirmed as to the disallowance of any interest thereon.

MORRIS J. LEVY, New York City, *for Plaintiff-Appellee-Appellant.*

ALBERT R. CONNELLY, Cravath, Swaine & Moore, Thomas A. Halleran, J. Eugene Farber, Robert Rosenman, John S. Gilbert, New York City, *for Defendants-Appellants-Appellees.*

PHILIP A. LOOMIS, JR., Gen. Counsel; Walter P. North, Assoc. Gen. Counsel; Meyer Eisenberg, Special Counsel; Gus J. Bennet, Attorney, *on brief for Securities and Exchange Commission, amicus curiae.*

WATERMAN, *Circuit Judge:*

The plaintiff-appellee-appellant, Isadore Blau, a stockholder of Air-Way Industries, Inc. (Air-Way), a Delaware corporation, commenced this action pursuant to Section 16(b) of the Securities Exchange Act of 1934, 15 U. S. C. § 78p(b), to recover "short-swing" profits allegedly realized by the defendants-appellants-appellees, Edward Lamb (Lamb) and Edward Lamb Enterprises, Inc. (Enterprises), an Ohio corporation, as a result of their respective short-

term dealings in the convertible preferred stock and common stock of Air-Way.[1] Jurisdiction and venue in the district court were proper under Section 27 of the Act, 15 U. S. C. § 78aa. *Blau* v. *Lamb,* 20 F. R. D. 411 (SDNY 1957). See 2 Loss, *Securities Regulation* 1044-45 (2d ed. 1961).

For reasons to be considered hereinafter the court below entered a final judgment on June 5, 1965, holding Lamb liable to Air-Way for "short-swing" profits amounting to $206,356.45 and Lamb and Enterprises jointly and severally liable to Air-Way for "short-swing" profits amounting to $1,091,063.31. *Blau* v. *Lamb,* 242 F. Supp. 151 (SDNY 1965). Lamb and Enterprises have appealed on the ground that the transactions in which they engaged did not involve "purchases" or "sales" or, in any event, that the transactions did not result in any "profit realized" within the meanings of those three terms as the terms are used in Section 16(b) of the Act. They contend further that even if all the relevant transactions are within the scope of Section 16(b) the court below grossly overvalued the "profit realized." Blau has appealed on the grounds that the lower court undervalued the "profit realized," that certain cash dividends for which recovery was denied are recoverable, and that interest should have been added to the amount held recoverable. The Securities and Exchange Commission was granted permission to submit a brief, *amicus curiae,* in order to express its views upon certain of the issues presented by the appeal of Lamb and Enterprises.

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[1] It has already been decided that Blau has sufficient indicia of ownership to bring this action. *Blau* v. *Lamb,* 314 F. 2d 618 (2 Cir. 1963). On December 31, 1958, Air-Way changed its name to Lamb Industries. In this opinion we will refer to the parties as they were named in 1955.

Appendix.

I. *The Factual Background.*

The present lawsuit arises out of a complicated series of transactions in the Convertible Preferred Stock and the common stock of Air-Way, carried on by Enterprises and Lamb during 1955. We set forth this series of transactions chronologically before turning to consider the question of Section 16(b)'s application to any of them.

In June of 1955 and throughout the relevant period Lamb was an officer and director of Air-Way. Enterprises, which was a personal holding company for Lamb interests solely owned by Lamb, members of his immediate family, and corporations controlled by them, was the beneficial owner of more than 10 per cent of the outstanding common stock of Air-Way.[2] Lamb, members of his family, and certain corporations controlled by them were sufficiently in control of Air-Way to have elected 5 of that company's 7 directors. At all relevant times the common stock of Air-Way was registered for trading on the American Stock Exchange and was actively traded. Also, Enterprises and Lamb, together with members of Lamb's family, owned approximately 97 per cent of the outstanding shares of Lamb Industries, Inc. (Industries), an Ohio corporation they completely controlled. None of Industries' shares were ever listed on a national securities exchange.

In June 1955 the "Lamb interests" decided to merge Industries into Air-Way. On June 6, shortly before the stock-for-stock merger was finally approved by the Air-Way Board, Industries transferred to Enterprises 68,100 shares of Air-Way Common, which Industries had apparently held for more than six months, plus other assets, aggregating

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[2] Lamb and Enterprises were thus both "insiders" in their issuer, Air-way; Lamb because he was a director, and Enterprises because it was the beneficial owner of more than 10 per cent of Air-Way's stock. See note 6 *infra*.

$227,850. Industries received in exchange 40,002 shares of Industries (its own) Common Stock plus the assumption by Enterprises of a $581,250 note that Industries had given to a bank.

On June 9, 1955, the Air-Way Board approved an offer to the shareholders of Industries to exchange one share of newly-created 5 per cent Cumulative Convertible Preferred Stock of Air-Way (Air-Way Preferred) for each five shares of Industries Common. The par value of the Air-Way Preferred was $50, it had a liquidation value of $52.50 plus accumulated dividends, and was convertible at any time into Air-Way Common at a ratio of 3½ shares of Air-Way Common for each share of Air-Way Preferred. In the event of any stock dividend, or split-up by reclassification, or by any other method, of the shares of Air-Way Common, the number of shares into which the shares of Air-Way Preferred were convertible would be appropriately adjusted. Each share of Air-Way Preferred carried a dividend of $2.50 a share per annum and was entitled to one vote.

From July through September 1955, in accordance with Air-Way's June 9 offer, Lamb exchanged 26,300 shares of Industries Common for 5,260 shares of Air-Way Preferred, and Enterprises exchanged 172,945 shares of Industries Common for 34,589 shares of Air-Way Preferred. On September 13, 1955 Enterprises converted its recently-acquired 34,589 shares of Air-Way Preferred into 121,061 shares of Air-Way Common. On September 13, 14, and 15, Lamb converted his recently-acquired 5,260 shares of Air-Way Preferred into 18,410 shares of Air-Way Common.

On September 12, 1955 Air-Way declared a 100 per cent stock dividend on its Common, in the nature of a stock-split, payable on October 14, 1955, to stockholders of record on September 29, 1955. The conversions by Lamb and Enterprises occurred on September 13, 14, and 15, 1955, after

the two-for-one stock dividend had been declared, and after the news of this declaration had been made public. On September 19, 1955, four days after the last conversion had occurred, Air-Way declared a cash dividend of 15 cents per share on its Common, payable November 1, 1955, to stockholders of record on October 24, 1955.[3]

On October 6, 1955 Enterprises privately sold 10,500 shares of Air-Way Common as constituted prior to the stock split to Industries, on October 13, 1955 Enterprises privately sold 6,500 shares of new Air-Way Common—that is, Air-Way Common after the 100 per cent stock dividend in the nature of a stock split—to the Edward Lamb Foundation, Inc., a charitable foundation, created and controlled by Lamb.[4] Other sales by Enterprises during the relevant period are not at issue on appeal.[5]

Certain facts that do not conveniently fit the foregoing chronological review of the relevant transactions are nevertheless important and are best stated now. On June 30, 1955 Air-Way declared a 30¢ per share dividend on the Air-Way Common then outstanding. Throughout the period relevant to this litigation Lamb and Enterprises, on various occa-

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[3] The regular quarterly dividend for the immediately preceding quarter was 30¢ per share. The 15¢ per share dividend declared on September 19, 1955 reflected the 2-for-1 split.

[4] The Directors of the Edward Lamb Foundation were Lamb, Lamb's wife, and Lamb's secretary. Although the 100 per cent common stock dividend in the nature of a stock split was declared by the Air-way Board on September 12, 1955, and was payable October 14 to stockholders of record as of September 29, and the sale by Enterprises to the Lamb Foundation occurred on October 13, both parties treat this sale as if it occurred on October 14 or thereafter and was of the new Air-Way Common.

[5] The district court found, and Lamb and Enterprises do not dispute the validity of this finding, that certain of Enterprises' purchases and sales of Air-Way Common in 1956 resulted in an insider's profit of $589, recoverable for the benefit of Air-Way.

sions, purchased and sold blocks of Air-Way Common on the American Stock Exchange. Lamb purchased 300 shares of Air-Way Common between March 18 and March 22, another 100 shares on May 13, and 200 more shares between September 2 and September 8. On September 15, on the American Stock Exchange, he sold 300 shares of Air-Way Common, as constituted prior to the 100 per cent stock dividend. This was the only relevant transaction in which Lamb disposed of shares of Air-Way Common to a purchaser other than a corporation controlled by him. Lamb also purchased on a "when-issued" basis 100 shares of new Air-Way Common on October 6 on the American Stock Exchange. Between May 2, 1955 and December 28, 1956, Enterprises purchased 1,700 shares of old Air-Way Common and 5,200 shares of new Air-Way Common.

II. *Purpose and Scope of Section 16(b).*

Section 2 of the Securities Exchange Act of 1934, 15 U. S. C. § 78b, states that the Act was designed, *inter alia*, "to insure the maintenance of fair and honest markets" in securities transactions. Section 16(b) helps to implement this overriding purpose by making it unprofitable for "insiders"[6] to engage in short-swing speculation. "Prior to the enactment of the Securities Exchange Act," the SEC has said, "profits from 'sure thing' speculation in the stocks of their corporations were more or less generally accepted by the financial community as part of the emolument for serving as a corporate officer or director notwithstanding the flagrantly inequitable character of such trading." 10

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[6] Section 16(a) states that an "insider" is any "person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security" of his issuer, "or who is a director or an officer of the issuer." 15 U.S.C. § 78p(a). Both Lamb and Enterprises were "insiders" in Air-Way. See note *2 supra*.

SEC Ann. Rep. 50 (1944). Among the inequitable short-swing transactions that prompted the enactment of Section 16(b) were transactions in which insiders, with advance knowledge of information that would produce a rise in the market price of a stock of their company, bought stock at the then current market prices and sold it when publication of the information had caused the anticipated rise to occur. And, too, there were transactions in which insiders with advance knowledge of facts that would depress the market price sold their stock at the then current prices and purchased stock when publication of the facts had had the expected depressing effect. Also, on occasion, the desire to obtain such profits had even led insiders to manipulate the market price of their corporation's stock by causing their corporation to pursue financial policies calculated to produce sudden fluctuations in market prices.[7]

Section 16(b) was enacted to "bring these practices into disrepute and encourage the voluntary maintenance of proper fiduciary standards." H. R. Rep. No. 1383, 73d Cong., 2d Sess. 13 (1934). The section provides that:

> For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner,

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[7] See S. Rep. No. 1455, 73d Cong., 2d Sess. 55-68 (1934); S. Rep. No. 792, 73d Cong., 2d Sess. 7-9 (1934); H. R. Rep. No. 1383, 73d Cong., 2d Sess. 13-14 (1934).

director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name of and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and the purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection. 15 U. S. C. § 78p(b).

Section 16(b), it should be emphasized, embodies a rather uncommon regulatory mechanism. The section's underlying purpose, as set forth in its preamble, is to prevent the "unfair use" of information by insiders. This purpose is effectuated by means of, what has been termed, a "crude rule of thumb."[8] In order to insure discouragement of unfair insider short term trading *all* inside trading within a less-than-six-month period is discouraged. The arbitrary, some might say Draconian, nature of this statute reflects the view of experts who testified at the hearings leading to the passage of the 1934 Act that the unfair use of information by corporate insiders could only be effectively curbed by a law that made it unprofitable for insiders to

[8] Hearings Before Senate Committee on Banking & Currency, 73d Cong., 2d Sess. 6557 (1934).

engage in any short-term trading, whether fair or unfair.[9] It might be said that Congress decided in order to throw out the bathwater that the baby had to go too. In order so to insure that Section 16(b) efficaciously put an end to unfair insider trading, Congress explicitly made irrelevant the intent of any insider who engages in a short-term transaction, and did not condition the section's application on proof of an insider's intent to trade on a short swing. The desire of Congress to prevent unfair insider trading, regardless of its form, is evident in the act's inclusive definitions of several of the section's important terms. Section 3(a)(11) defines the term "equity security" to include "any security convertible, with or without consideration, into such a security . . ."[10] Section 3(a)(13) broadly defines "purchase" as including "any contract to buy, purchase, or otherwise acquire,"[11] and "sale" is defined by Section 3(a)(14) as including "any contract to sell or otherwise dispose of."[12] A reasoned elaboration of Section 16(b)'s underlying purpose, plus the recognition that the section's success as a deterrent was rooted in its simplicity and relatively automatic operation, prompted our court to hold in an early case that proof of an actual unfair use of inside information was not required, saying that "the only remedy which its framers deemed effective for this reform was the imposition of a liability based upon an objective measure of proof." *Smolowe* v. *Delendo Corp.*, 136 F. 2d 231, 235 (2 Cir.), *cert. denied*, 320 U. S. 751 (1943). In order to insure that unfair use of information by insiders is prevented, courts have been equally quick to reject other arguably relevant considerations that would

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[9] *Ibid.*

[10] 15 U.S.C. § 78c(a)(11).

[11] 15 U.S.C. § 78c(a)(13).

[12] 15 U.S.C. § 78c(a)(14).

limit the broad reach and relatively automatic operation of that section. See 2 Loss, *Securities Regulations*, 1041-42 (2d ed. 1961).

It is equally important to emphasize that one issue is not finally resolved by the broad reach of Section 16(b) and the considerable evidence that Congress intended the section to deter unfair insider trading by rendering unprofitable all insider trading within any less-than-six-month period. It is quite apparent that because of the broad definitions of "purchase" and "sale" imported into Section 16(b), this section may be applied not only to routine cash purchases and sales of equity securities but also may be applied to acquisitions and dispositions of equity securities in transactions involving conversions, options, stock warrants, reclassifications and the like. It is perhaps less apparent but nonetheless true that as a matter of fact some of these transactions may not lend themselves in any way to an unfair use of inside information by corporate insiders.[13] Granting that the theory of regulation underlying Section 16(b) requires the application of this section to every transaction that might possibly permit an insider to use inside information unfairly, the unresolved question is whether 16(b)'s regulatory mechanism also requires the application of the section to a conversion transaction such as that involved here, which could not possibly serve as a vehicle for any of the abuses at which Section 16(b) was aimed. Put more generally, the unresolved issue is whether this particular type of regulatory mechanism renders inapplicable a well-known rule of construction: *cessante ratione legis, cessat et ipsa lex.*

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[13] See, e.g., *Blau* v. *Max Factor & Co.*, 342 F. 2d 304 (9 Cir.), cert. denied, 382 U. S. 892 (1965). See also Meeker & Cooney, The Problem of Definition in Determining Insider Liabilities Under Section 16(b), 45 Va. L. Rev. 949, 975 (1959).

Appendix.

With the background of this far from comprehensive brief restatement of Section 16(b)'s underlying purpose and of the regulatory mechanism Congress chose to effectuate this purpose, we now examine the section's application to each of the transactions which the court below held resulted in the short-swing profits for Lamb and Enterprises that were recoverable by Air-Way.

III. *Application of Section 16(b).*

A. *The Purchase and Conversion of Air-Way Preferred by Lamb and Enterprises.*

The district court held, and on appeal Lamb and Enterprises do not contest the holding, that the exchange with Air-Way in the summer of 1955 of Industries Common for Air-Way Preferred constituted a Section 16(b) "purchase" by Lamb and Enterprises of the Air-Way Preferred. The district court also held that the September 1955 conversion of the Air-Way Preferred into Air-Way Common constituted a Section 16(b) "sale" of the Air-Way Preferred, and went on to conclude that Lamb and Enterprises had "realized" a profit of $1,138,782.31 from this conversion, which was the difference between what it found to be the "cost" of the Air-Way Preferred (based upon its valuation of the Lamb Industries Common exchanged for the Air-Way Preferred) and the highest market price of the Air-Way Common on the relevant dates of conversion. Lamb and Enterprises maintain that this conversion did not constitute a "sale" resulting in any "profit realized" within the intendment of Section 16(b). Blau contends the district court's only error was in undervaluing the "profit realized" that resulted from the sale. For reasons given hereafter we reverse the district court and hold that the conversion of Air-Way Preferred into Air-Way Common

was not a Section 16(b) "sale" by Lamb or Enterprises. Thus we do not reach the valuation issue raised by Blau.

The question to be decided is whether a conversion of preferred stock into common constitutes a Section 16(b) "sale" of the preferred. It is possible to resolve this question by holding that the broad reach of Section 16(b), the unambiguous legislative history stating that Congress intended the section to deter unfair insider trading by rendering unprofitable all "insider trading" within any less-than-six-month period, and early judicial declarations that the section embodies an "objective" test of insider liability,[14] require the unstinting application of this section to any exchange of shares that can be described as a "purchase" or a "sale." One can, as a matter of language, describe the conversion of a company's convertible preferred stock into an equivalent amount of common stock as a "disposition" or "sale" of one equity security (the preferred) and an "acquisition" or "purchase" of another (the common). Thus it follows from this approach to the problem that, if the conversion can be paired with another "sale" or "purchase," and the paired transactions occur within a six month period, the paired transactions are, without further inquiry, the type of insider activity that Section 16(b) was designed to prevent. A 1947 decision of our court, authored by Judge Clark, has become the model of this approach to the problem of the section's application. *Park & Tilford, Inc.* v. *Schulte,* 160 F. 2d 984 (2 Cir.), *cert. denied,* 332 U. S. 761 (1947). In *Park & Tilford* the defendants held preferred and common representing a controlling interest in the company. In late 1943 and early 1944 the market price of the common rose significantly. The company served notice of redemption of its preferred stock on December 20, 1943. On January 19, 1944, the defendants

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[14] See Section II *supra.*

converted their preferred into common and within six months they sold the common. Holding the defendants liable for insider profits, Judge Clark stated, 160 F. 2d 987:

> We think a conversion of preferred into common stock followed by a sale within six months is a "purchase and sale" within the statutory language of § 16 (b). Whatever doubt might otherwise exist as to whether a conversion is a "purchase" is dispelled by definition of "purchase" to include "any contract to buy, purchase, or otherwise acquire." § 3(a)(13). Defendants did not own the common stock in question before they exercised their option to convert; they did afterward. Therefore they acquired the stock within the meaning of the Act.

This language certainly suggests that every conversion should be said to involve a Section 16(b) "purchase" of the common, subjecting the insider to liability if the conversion can be paired with a "sale" of common within a less-than-six-month period and the paired transaction shows a profit to the insider. Several courts have read *Park & Tilford* as standing for precisely such a rule. E.g., *Heli-Coil Corp.* v. *Webster,* 352 F. 2d 156 (3 Cir. 1965); *Pettys* v. *Northwest Airlines, Inc.,* 246 F. Supp. 526 (D. Minn. 1965); cf. *Blau* v. *Hodgkinson,* 100 F. Supp. 361 (SDNY 1951). Of course, *Park & Tilford* dealt specifically with whether a conversion should be considered a Section 16(b) "purchase" of the common. Recently, however, the Third Circuit has concluded that precisely the same approach required an affirmative answer to the question whether a conversion is a Section 16(b) "sale" of the preferred. *Heli-Coil* v. *Webster, supra.*

We do not agree that we should, without further inquiry, so resolve the question of whether a conversion of pre-

ferred stock into common constitutes a Section 16(b) "sale" of the preferred. Certainly we are not compelled to do so by any Second Circuit precedent. Aside from the intimations to the contrary in *Park & Tilford,* our court appears always to have recognized that in deciding whether a certain transaction is a Section 16(b) "purchase" or "sale" it is relevant to first consider whether the transaction in any way makes possible the unfair insider trading that Section 16(b) was designed to prevent. For example, in a 1954 case in this Circuit, insiders owning more than 45 per cent of their company's single class of common stock arranged for the company's stock to be reclassified into a new class of preferred and a new class of common in order to improve the marketability of their interest in the company. Within six months of the exchange incident to the reclassification the insiders sold the new securities at a profit. In an opinion authored by Judge Clark, our court held that the insider's acquisition of the newly created common and preferred was not a "Section 16(b) purchase" of this stock. *Roberts* v. *Eaton,* 212 F. 2d 82 (2 Cir.), *cert. denied,* 348 U. S. 827 (1954). The court reasoned that the "cumulative effect" of several factors established that the "reclassification at bar could not possibly lend itself to the speculation encompassed by § 16(b). This being so, it was not a 'purchase' . . . " 212 F. 2d at 86. See also *Shaw* v. *Dreyfus,* 172 F. 2d 140 (2 Cir.), *cert. denied,* 337 U. S. 907 (1949); *Truncale* v. *Blumberg,* 80 F. Supp. 387 (SDNY 1948). In 1960, Judge Medina, in a considered dictum, stated that he understood the rule to be that a "transaction is a 'purchase' if in any way it lends itself to the accomplishment of what the statute is designed to prevent." *Blau* v. *Lehman,* 286 F. 2d 786, 792 (2 Cir. 1960), *aff'd,* 368 U. S. 403 (1962). The view that Section 16(b)'s purpose can be fully accomplished without subjecting to 16(b) sanctions every transaction describable in its

terms has also commended itself to other United States Courts of Appeals. In a case, like *Park & Tilford,* involving a conversion and subsequent sale of common, the Sixth Circuit held the conversion was not a Section 16(b) "purchase" of the common on the ground that, under the circumstances of that case, the conversion "was not one that could have lent itself to the practices which Section 16(b) was enacted to prevent." *Ferraiolo* v. *Newman,* 259 F. 2d 342, 346 (6 Cir. 1958), *cert. denied,* 359 U. S. 927 (1959).[15] And the Ninth Circuit recently adopted the same approach when faced with deciding whether an insider's conversion of one class of outstanding common into another class of outstanding common with different dividend attributes constituted a Section 16(b) "purchase" of the latter. *Blau* v. *Max Factor & Co.,* 342 F. 2d 304 (9 Cir.), *cert. denied,* 382 U. S. 892 (1965).

Thus far we have only established that the decided cases in this and other circuits do not require us to hold that, without further analysis, the conversion of Air-Way Preferred into Air-Way Common must be regarded as a Section 16(b) "sale" of the Air-Way Preferred. Instead, most of the appellate decisions, including the more recent decisions of our court, state that the application of Section 16(b) depends upon whether the transaction in question

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[15] In *Ferraiolo,* as in *Park & Tilford,* the issuer served notice of redemption of the preferred stock and thereafter the insider converted. The Sixth Circuit distinguished *Ferraiolo* from *Park & Tilford* on the ground that the insider did not control the issuer whereas in *Park & Tilford* the insider had a voting majority and thus absolute power to determine whether the preferred stock should be called for redemption. Insider control may indeed explain *Park & Tilford.* See 2 Loss, *Securities Regulation* 1067 (2d ed. 1961). But the absence of insider control is not a total explanation of *Ferraiolo. Ferraiolo* instead stands for the proposition that Section 16(b) need not be applied to every single transaction describable in its terms; that is, for the aproach to the section's application that we are adopting.

could tend to accomplish what the section was designed to prevent. *Contra, Heli-Coil Corp.* v. *Webster, supra.* It is, of course, clear that this judicial limitation on the reach of Section 16(b) is perfectly consistent with the section's underlying purpose of preventing the unfair use of inside information by corporate insiders. This underlying purpose provides no reason for the application of Section 16(b) to a transaction that poses no danger whatever of insider abuse. Nevertheless, it is arguable that the regulatory mechanism chosen by Congress to effectuate Section 16(b)'s underlying purpose may have removed the power a court otherwise would have to hold that this legislative command should not apply to a transaction that could not possibly permit the mischief the legislature wished to remedy. The argument for such a position recognizes that in Section 16(b) Congress chose to effectuate the section's underlying purpose by making it unprofitable for insiders to engage in any trading at all within any less-than-six-month period and emphasizes that Congress contemplated that the section would be applied to transactions that did not involve unfair insider trading. In other words, this argument is based upon the proposition that Congress by choosing to regulate in this fashion implicitly forbade the federal courts to have recourse to the maxim *cessante ratione legis, cessat et ipsa lex* as a tool of construction in close cases. We do not find this argument persuasive. To be sure, the theory of regulation underlying Section 16(b)'s regulatory mechanism provides a sufficient reason for refusing to examine the details of transactions once it has been determined that they might possibly have served as vehicles for unfair insider trading. But it does not supply an equally sufficient reason for applying Section 16(b) in this same automatic fashion when a substantial question is raised whether a certain conversion transaction permits a possibility of insider abuse. Congress adopted the sweep-

ing, arbitrary regulatory mechanism embodied in Section 16(b) in order to insure that even the possibility of insider abuse was deterred, but it would seem to follow that in order to avoid "purposeless harshness" a court should first inquire whether a given transaction could possibly tend to accomplish the practices Section 16(b) was designed to prevent. *Blau* v. *Max Factor & Co., supra,* at 307. Frequently this initial inquiry will convince a court that the transaction in question held out at least the possibility of abuse; in such cases Section 16(b)'s regulatory mechanism requires that the section be applied without further inquiry. In some cases, however, this initial inquiry will convince a court that the conversion transaction in question could not possibly have lent itself to insider abuse. In such a case it is not inconsistent with Section 16(b)'s regulatory mechanism to hold that the section does not apply.

One further point deserves brief notice. In *Heli-Coil Corp.* v. *Webster, supra,* a majority of the Third Circuit concluded that Congress intended Section 16(b) to be "entirely objective." 352 F. 2d at 165. The limitation on Section 16(b)'s application we here adopt was there rejected on the ground that decision as to whether a certain transaction could possibly lend itself to the abuses Section 16(b) was designed to prevent "must be determined to some degree at least by the minds of the finders of fact," 352 F. 2d at 164, and thus imported an impermissible "subjective" consideration into the task of applying the section. We consider this observation unobjectionable but point out that it is irrelevant. Of course, the inquiry whether a certain transaction lends itself to the accomplishment of what Section 16(b) is designed to prevent must be decided "by the minds of the finders of fact." This is true of the task of law application generally. There is no rule so "objective" ("automatic" would be a better word) that it does not require some mental effort in applying it on the part of the person or persons entrusted by law with its application.

We thus turn to consider whether the conversion of Air-Way Preferred into Air-Way Common in September 1955 by Lamb and Enterprises in any way lent itself to the accomplishment of what Section 16(b) was designed to prevent. The court below answered this question affirmatively. 242 F. Supp. at 157. It held that the conversion was a Section 16(b) "sale" of the Air-Way Preferred, which, when matched with the earlier "purchase" of the Preferred by Lamb and Enterprises, rendered Lamb and Enterprises liable for insider profits. The district court's decision appears to rest on two rather separate grounds. First, the court said that in view of the circumstances surrounding the purchase of the Air-Way Preferred and its subsequent conversion, "it requires little imagination to infer . . . a corporate milieu rife with opportunities for speculation and misuse of inside information." 242 F. Supp. at 157. Second, the court seems to have implicitly conceded that an insider's conversion of preferred into common should not be deemed a Section 16(b) "sale" if the common is economically equivalent to the preferred, but it went on to say that the "simple answer" to this contention in this case was that by converting the preferred Lamb and Enterprises "received a totally different security with an attendant alteration in the risks and advantages involved." 242 F. Supp. 157-58. We disagree with both grounds the district court advanced in support of its decision.

In support of its contention that the preferred stock transaction lent itself to the accomplishment of "speculation and misuse of insider information" the district court noted that Lamb controlled Air-Way and was the "guiding force" behind the merger of Industries into Air-Way; that the immediate purpose of the merger was to graft onto Air-Way a management team Lamb had previously recruited for Industries; that Air-Way's noncontrolling stockholders were not asked to approve the merger until that company's

next annual meeting in March 1956; that the conversion of Air-Way Preferred by Lamb and Enterprises was "voluntary";[16] and that by so converting Lamb was able to increase his holdings of Air-Way Common, consequently tightening his grip on that company. After enumerating these facts, without further analysis, the lower court concluded that the situation was "rife with opportunities for speculation and misuse of inside information." We have a substantial problem with this approach. The factors enumerated do serve to emphasize Lamb's control of Air-Way. He was in a position to direct the stock-for-stock merger at an exchange ratio apparently favorable to holders of Industries Common[17] without the formal approval of all Air-Way shareholders expressed at an annual meeting,[18] and, when he converted, his position as a controlling insider became even more secure. As controlling insiders Lamb, and Enterprises, clearly had the power to misuse inside information for speculative purposes.[19] But the question

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[16] By saying that the conversion in the present case was "voluntary" the court below intended to distinguish *Ferraiolo*. See note 15 *supra*. We agree that the conversion was "voluntary." But we do not attach determinative consequences to this conclusion.

[17] The gravamen of Blau's complaint sometimes appears to be that the rate at which Air-Way Preferred shares were exchanged for Industries' Common in the merger was too favorable to owners of Industries shares.

[18] There is no suggestion that the accomplishment of this merger in this fashion violated any applicable corporate law. Lamb might have put the stock-for-stock merger plan to a vote at an Air-Way annual meeting, but apparently he was not required to do so.

[19] Even a noncontrolling "insider" has the power to misuse inside information for speculative purposes by trading in light of the inside information to which he is privy. A "controlling insider" also can manipulate corporate activity in order to create favorable short-swing trading situations. But certain types of transactions may not present any opportunity for the exercise of either "noncontrolling" or "controlling" insider power to misuse inside information.

remains: Did the conversion present Lamb or Enterprises with even the slightest opportunity to exercise that power? The facts enumerated by the district court, standing alone, fail to establish that the conversion in any way made it possible for Lamb either personally, or through Enterprises, to reap speculative profits based on insider information.[20] And we reject the possible suggestion in the lower court's opinion that the existence of an opportunity for speculative profits can be inferred from the fact of control alone,[20a] because such a suggestion is inconsistent with our responsibility to analyze the conversion in order to determine whether the possibility of unfair speculative profits might have existed at all even with full corporate control. Lamb's attempt to bolster his control of Air-Way by acquiring and then converting Air-Way Preferred may fall short of our aspirations for the conduct of controlling shareholders. But, to paraphrase Judge Clark, speculation, actual or potential, is the only vice within the purview of Section 16(b). Other possible corporate abuses that can possibly arise out of stock conversions do not now concern us. *Blau* v. *Ogsbury*, 210 F. 2d 426, 427 (2 Cir. 1954). See *Smolowe* v. *Delendo Corp., supra*, at 235.

The second ground advanced by the court below in support of its decision requires more elaborate analysis. Lamb and Enterprises maintain that, in general, the purchase by an insider of his issuer's convertible securities, followed in less than six months by their conversion, cannot facilitate short-swing trading for speculative profits in the convertible securities because normal market activity,

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[20] See note 24 *infra*.

[20a] Of course, the activities of insiders in transactions within the possible ambit of Section 16(b) may take many forms, and in this opinion we limit the applicability of our observations to situations similar to the one presently before us.

including arbitrage trading, will insure that the convertible securities have a market price at least equivalent to the aggregate price of the securities into which they are convertible, if the value of the conversion security is in excess of the investment value of the convertible security without the conversion privilege.[21] We agree with this general proposition and believe that it is applicable in the present case. It is not seriously disputed that when the Air-Way Preferred was converted its market price was equivalent to the market price of the number of shares of Air-Way Common into which it was converted. True, the market value of the Air-Way Common received by Lamb and Enterprises on each relevant conversion date was higher than their cost in the Air-Way Preferred; but the market value of the Air-Way Preferred that was converted on each date fully reflected that appreciation over their cost. Furthermore, after the conversion, Lamb and Enterprises retained the investment position in the securities of Air-Way that they had acquired during the summer of 1955. The appreciation in the value of this position that had occurred since then continued to be at the risk of the market and could disappear if the market price of the common thereafter declined. In view of this situation, it would seem to be a cold fact of the market that the conversion could not afford Lamb or Enterprises opportunities to realize a trading gain based on speculative judgment exercised when they purchased the Air-Way Preferred. Indeed, by converting, Lamb and Enterprises would appear to have reduced their opportunity for speculation because they surrendered the protection of a senior position and gained no compensating advantage. Ordinarily an investor would convert in this situation, where the convertible security is

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[21] See Graham, Dodd & Cottle, Security Analysis, 603-04 (4th ed., 1962).

protected against dilution and has not been called for redemption, only because he hoped to gain a long-term benefit from receiving dividend income in excess of the dividend payable upon the convertible security. Here the conversion would appear to have been prompted by Lamb's desire to increase his control of Air-Way. But whatever the motives that prompted this conversion, we hold that the economic equivalence of the Air-Way Preferred and the Air-Way Common and the unchanged investment position of Lamb and Enterprises combined to insure that this conversion afforded the insiders no opportunity to realize a gain by speculative trading in Air-Way Preferred. For this reason, we hold that the conversion was not a Section 16(b) sale of the Preferred. See *Heli-Coil Corp.* v. *Webster, supra,* at 172-73 (Hastie and Kalodner, *JJ.*, dissenting in part). See also *Blau* v. *Max Factor & Co., supra.*

The district court implicitly recognized the force of much of this argument based on economic equivalence and unchanged investment position; yet it held that the Air-Way Common was not the economic equivalent of the Air-Way Preferred and that Lamb and Enterprises had substantially changed their investment position. It reached this result by noting that the Common conferred greater voting power, permitted greater dividends, and was more easily marketed. In the present case we do not find these facts determinative of the issues posed by Section 16(b), and disagree with the result the district court reached. It is true that the conversion increased the voting power of Lamb and Enterprises. Each share of Air-Way Preferred had one vote and each of the 3½ shares of Air-Way Common (or, after the two-for-one split, 7 shares of Air-Way Common) obtainable upon conversion had one vote. However, the increase in voting power would seem to be irrelevant to the central question whether the conversion facilitated short-swing trading in the Air-Way Preferred. If

the voting power of the Air-Way Common had value, that value would be forthwith reflected in the value of the Air-Way Preferred because the Preferred was immediately convertible into Air-Way Common. In short, the increased voting power incident to the conversion conferred no trading advantage "and, therefore, is not relevant to our present problem." *Heli-Coil Corp.* v. *Webster, supra* at 172 (Hastie and Kalodner, *JJ.*, dissenting in part). Parallel reasoning leads us to the conclusion that the different dividend attributes of the Air-Way Preferred and the Air-Way Common are also irrelevant for present purposes because this difference did not present Lamb and Enterprises with the possibility of reaping a trading advantage.[22] Cf. *Blau* v. *Max Factor & Co., supra.* Finally, we

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[22] It might be argued that a conversion from preferred to common with different—potentially more generous—dividend attributes involves at least the possibility of insider abuse and thus should be brought within the ambit of Section 16(b). The argument would be that a controlling insider could purchase convertible securities of his issuer, engineer the declaration of dividends on the common and then convert just prior to the public announcement of the dividend. The difficulty with this argument is that this danger exists independently of short-term trading by controlling insiders in their issuer's stock. For example, in the stated hypothetical, precisely the same opportunity for abuse would exist if the insider had held the convertible security for many more than six months. Furthermore, the insider need not dispose of the common he acquired in order to reap the benefit of the extravagant dividend payout he has arranged. We do not believe Section 16(b) should be used to remedy the problem of insider-inspired excessive dividend payouts when there exists no Section 16(b) "sale" and "purchase" giving rise to the possibility that insiders could realize short-swing trading profits. Support for this position is found in the language of Section 16(b): it speaks of recovering "profit realized . . . from any purchase and sale, or any sale and purchase." It does not provide for the recovery of unfair dividend payouts standing alone; yet in the above hypothetical this is all that can be called unfair. It would be perverse to conclude that the factors of economic equivalence and unchanged in-

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do not believe that it was appreciably more difficult to market Air-Way Preferred than Air-Way Common. Anyone wishing to sell Air-Way Preferred needed only to convert it into Air-Way Common, which was listed on the American Stock Exchange. We cannot agree with the district court's conclusion that the relative marketability of these securities destroyed their otherwise economic equivalence. *Ibid.*

The limitations inherent in our holding, the questions it leaves unresolved, and some general observations on its scope should be set forth, lest we be misunderstood. We do not hold that the economic equivalence of that which an insider surrenders and that which he receives in an exchange always, or even usually, will suffice to remove the exchange from the ambit of Section 16(b). To the contrary, sales or purchases by an insider of his issuer's securities for cash, the securities of a different company, or other property are within the reach of Section 16(b), even though, if these are arms-length transactions, each side will receive what it considers to be at least economically equivalent to what it surrendered. Focus on the factor of economic equivalence is only relevant when—as in a conversion or a reclassification—that which the insider surrenders and that which he receives are simply different forms of the same participation in his issuer. Second, it should be

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vestment position combine to insure that a conversion such as this cannot afford insiders any opportunity to realize short-swing trading gains and then conclude that the possibility of insider-inspired, excessive dividend payouts, which cannot be recovered alone, requires that the insider's unrealized gains be recovered by their issuer. Of course, in the above hypothetical, Section 16(b) might apply if a *sale* of the common occurred within six months from the purchase of the convertible security. See text accompanying note 25 *infra*.

"We also take pains to point out that what we say here in no way modifies the rule of this Circuit as to when dividends received by an insider are includable in an otherwise recoverable "profit realized." See *Alder* v. *Klawans*, 267 F. 2d 840, 849 (2 Cir. 1959).

noted that the "economic equivalency" argument may not necessarily be of equal relevance in each of the four prototype situations in which a conversion may be paired with another transaction in an attempt to establish a violation of Section 16(b).[23] For reasons previously stated, we find the argument persuasive in the case of an admitted purchase by an insider of his issuer's preferred followed less than six months later by the preferred's conversion into common. For the time being, we leave open the further question whether this argument is equally persuasive in the second situation—the conversion by an insider of his issuer's preferred, which has been held for more than six months, followed less than six months later by a new purchase of his issuer's preferred at a lower price. We also leave open the relevance of "economic equivalence" in the third and fourth prototype situations when the question is whether a conversion is a Section 16(b) "purchase" by an insider of his issuer's common, and, in the one case, an admitted sale of his issuer's common at a higher price precedes that conversion by less than six months, and, in the other, an admitted sale follows the conversion by less than six months. We do think it is clear that "logic" does not require that "economic equivalence" be equally relevant in each of these four prototype situations; nor does it follow logically that because one of these four prototype situations may possibly facilitate short-term speculative trading all do. In the first two prototype situations the question is whether the conversion facilitates short-term speculative trading in the issuer's preferred. The question in the latter situations is whether the conversion facilitates short-term speculative trading in the issuer's common. It

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[23] Of course, more variations can be worked out if conversions are paired with other conversions, reclassifications or the like. Here we are concerned simply with the variations that arise when a conversion is paired with an admitted purchase or sale.

also may make a difference whether the admitted purchase or sale precedes the conversion as in the present and in the third situations, or whether it follows the conversion as in situations two and four. Third, this analysis should serve to emphasize that when a court examines a particular transaction to determine whether it might possibly have facilitated unfair insider trading it should first ascertain whether there existed any possibility of abuse presented by the prototype situation the court has before it. Thus, in the present case, if we assume for the moment that, despite the factor of economic equivalence, a conversion followed by a sale of the common facilitates speculation in the common, this is a sufficient reason for considering the conversion a Section 16(b) "purchase" of the common; but it is not, standing alone, a reason for concluding that the conversion should be considered a Section 16(b) "sale" of the preferred. In order to support this latter conclusion it must be established that the conversion in some way facilitated short-term speculative trading in the preferred; this has not been established here.[24] Finally, at the risk of

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[24] A majority of the Third Circuit in *Heli-Coil Corp.* v. *Webster*, *supra* at 165 suggested that an insider with inside information of the date on which debentures will be called by his issuer can reap a trading advantage by converting "for when the debentures are called they are no longer tied to the price of the stock. In advance of the information respecting the call being made public, if the insider has any knowledge that will affect the future price of the common stock, such as an increased dividend to be paid after the senior security has been retired, he would be in a position to profit by his conversion." *Ibid.* *We disagree.* All convertible securities provide for notice, usually of at least 30 days, prior to the redemption date. During the period after notice and before redemption the convertible securities may be converted. In fact, notice of redemption is normally a means of forcing conversions. During the period after the notice of redemption is given and while the security is still convertible at any time, it remains the market equivalent of the common. Therefore, the holder of the convertible security who has

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being obvious, we simply note that "economic equivalence" has no relevance in a situation where the convertible security did not trade at a price at least equivalent to the aggregate price of the securities into which it was convertible.

We think that in cases like the present involving the purchase of a convertible security and its subsequent conversion, the issue should be whether the underlying security has been sold within six months from the acquisition of the convertible security. See *Heli-Coil Corp.* v. *Webster, supra,* at 171-74 (Hastie and Kalodner, *JJ.*, dissenting in part). Where the convertible security is purchased, converted, and the underlying security sold, all within less than six months, we believe the entire profit resulting from the transaction is recoverable, either on the theory that the accrued profit on the preferred as well as the profit on the common has been realized, "within . . . [a] period of less than 6 months" for purposes of the statute, or else upon the theory that, under such circumstances, the pur-

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inside knowledge of the redemption is not in any better position than the person without such inside information. The plaintiff also has attempted to demonstrate how Lamb's and Enterprises' conversions enabled them to capitalize on inside information. He states that the market price of Air-Way Common increased 20 per cent in the two-months period between the time Lamb and Enterprises acquired and converted the Air-Way Preferred. Blau goes on to argue that this market increase was caused by the 100 per cent stock dividend and the declaration of the regular quarterly dividend in September. Blau concludes that Lamb and Enterprises could only capitalize on this increase in value by converting. *We disagree.* If they had not converted and the market price of the Air-Way Common had increased, as it did, the value of the Air-Way Preferred would have increased to the same extent. By holding their investment in the form of Air-Way Common rather than in the form of Air-Way Preferred, Lamb and Enterprises did not obtain any greater investment value. Their investment in Air-Way was still at *risk.* We should always have in mind that a holder of Air-Way Preferred could choose to convert to Air-Way Common whenever he wished to do so.

chase of a convertible preferred may be treated as a purchase of common stock, for the statute defines "purchase" as including "any contract to buy, purchase or otherwise acquire," and the purchase of the convertible security includes a contractual right to acquire the conversion security. This view of the statute is reflected in amended Rule 16b-9 recently adopted by the Securities & Exchange Commission, effective February 17, 1966, and applicable to all transactions occurring after that date. *Securities Exchange Act Release* No. 34-7826 (Feb. 17, 1966). Amended Rule 16b-9 provides an exemption from the ambit of Section 16(b) for the conversion of an equity security, which is convertible into another equity security of the same issuer, provided that no more than fifteen per cent of the value of the security received at the time of the conversion is received or paid in cash or other property. *Ibid.* The stated reason for this exemption is that, in the judgment of the Commission, the conversion of a convertible security into its conversion security is not "comprehended within the purpose of Section 16(b) . . ." *Ibid.* We agree. Furthermore, for all of the above reasons, we hold that the same is true of conversion involved in the present case.[25]

B. *Transactions Between Enterprises and Other Corporations Controlled by Lamb.*

The district court held that the transaction on June 6, 1955 in which Enterprises acquired from Industries 68,100 shares of Air-Way Common plus other assets was a Section 16(b) "purchase" by Enterprises, which the lower

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[25] The Securities and Exchange Commission as *amicus* urges that we reach the result we here reach. The Commission would have us so hold on the ground that the conversion was a Section 16(b) sale of the Air-Way Preferred but no profit was realized at that time. See *Heli-Coil Corp.* v. *Webster, supra.*

court then matched against the October 6, 1955 sale by Enterprises to Industries of 10,500 shares of Air-Way Common and the October 13, 1955 sale by Enterprises to the Edward Lamb Foundation, Inc. of 6,500 shares of new Air-Way Common.[26] Thus the district court held Lamb and Enterprises jointly liable for short-swing profits totaling $153,526.50.[27] Lamb and Enterprises appeal this determination, contending *inter alia* that the June 6, 1955 transaction was not a Section 16(b) "purchase" by Enterprises. The Securities and Exchange Commission also urges that we adopt this view. For reasons given hereafter we reverse the district court and hold that the June 6, 1955 transaction was not a "purchase" by Enterprises within the meaning of Section 16(b).

It must be recalled that on June 6, 1955 Lamb controlled 100 per cent of the stock of Enterprises and 97 per cent of the stock of Industries—the remaining 3 per cent was owned by several employees or former employees of Industries. By virtue of Lamb's pervasive control over Industries and Enterprises, there was at most a token change in the insider's investment position when Air-Way

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[26] By October 1955 Industries had become a subsidiary of Air-Way as a result of the exchange of Industries Common for Air-Way Preferred. Whereas in June 1955 Lamb had owned 97 per cent of Industries, in October Lamb's interest in industries was as a holder of in excess of 50 per cent of the Air-Way Common.

[27] If the amount Enterprises received on the October 13, 1955 sale is matched against the purchase price it paid on June 6, 1955 for 6,500 shares there is no profit on the paired transaction. But the district court held that, since there was a "short-swing" transaction, the value of the stock dividend in the nature of a 2-for-1 split was recoverable in its entirety. This totaled $60,937.50; the value of the 6,500 shares issued as a stock dividend on the 6,500 acquired on June 6, based upon a market high of $9⅜ on the date of payment. Our holding that the June 6, 1955 transaction was not a Section 16(b) "purchase" by Enterprises permits us to avoid discussion of the lower court's treatment of a stock dividend as a recoverable profit.

Common was transferred from Industries to Enterprises; Lamb indirectly owned this stock both before and after its transfer. Thus Lamb did not place himself where he could make any more advantageous use of inside information for speculative purposes than he could have before the transfer. Nor did the decision to transfer the Air-Way Common alter the nature of his investment, increase or decrease the amount invested, or alter in any way the risks involved.

The rule announced by Judge Clark in the first half of *Blau* v. *Mission Corp.*, 212 F. 2d 77 (2 Cir.), *cert. denied*, 347 U. S. 1016 (1954) seems applicable here. In that case a parent corporation, which was an insider in Tide Water Associated Oil Company because of stock ownership in excess of 10 per cent, transferred a substantial block of Tide Water stock to its (the parent's) wholly-owned and newly-organized subsidiary holding company established for that purpose. Our court held that this transfer was "mere bookkeeping without the reach of the statute" and thus was not a Section 16(b) "sale." 212 F. 2d at 81. After characterizing the transaction as "a mere transfer between corporate pockets," this court also said, 212 F. 2d at 80:

> To hold otherwise would be to place entirely undue stress on the corporate fiction reaching harsh and wooden results quite unnecessary to achieve the purposes of the act. Until, going beyond the corporate forms, some new individuals entitled to share in the ultimate profits enter the picture there has been no real sale of stock.

In the present case the district court rejected the analogy between the first transaction in *Mission Corp.* and the transfer of Air-Way to Enterprises. In doing so, the court below stressed the absence of complete ownership of the Industries stock by Lamb. It concluded that the rule of the first half of *Mission Corp.* should be applied only to

cases involving 100 per cent ownership because there were no "precise and generally applicable criteria" that would enable courts to know how much control less than 100 per cent was enough to invoke this rule. 242 F. Supp. at 159. We sympathize with this position because we have been unable to formulate a bright-line rule as to how much stock control is enough to invoke the rule. Nevertheless, we agree with the Securities and Exchange Commission's conclusion that in the present case the amount of Industries stock not owned by Lamb—approximately 6,000 of 196,000 shares—is not sufficient to affect the unity of interest between Lamb, Enterprises and Industries. The transfer to Enterprises of the Air-Way Common in no way increased Lamb's power to make use of inside information, and for this reason that transfer was not a Section 16(b) "purchase" of the Common.

C. *Other Transactions.*

On September 15, 1955 Lamb sold 300 shares of Air-Way Common on the American Stock Exchange. The district court matched that sale against the "purchase" by Enterprises of 300 shares on June 6, 1955 as part of the 68,000 shares acquired from Industries on that date. According to the lower court this resulted in a recoverable profit of $2,702.52. Lamb does not challenge the matching of transactions by him against transactions by Enterprises, which corporation was 100 per cent controlled by Lamb and his family. However, because we have held that the June 6, 1955 transaction was not a Section 16(b) "purchase" of Air-Way Common by Enterprises, this portion of the lower court's decision must also be reversed. Nevertheless, it would seem proper to match Lamb's September 15, 1955 sale of 300 shares of Air-Way Common (sold at a price totaling $5,757.12) against the Lamb purchases of 300 shares of Air-Way Common on the American Stock Exchange between March 18, 1955 and March 22, 1955 (at a

cost of $4,091.10), which results in a profit recoverable from Lamb by Air-Way amounting to $1,666.02.[28] We affirm to this extent.

In two instances the court below computed "realized profits" by comparing the market price of Air-Way Common prior to the 100 per cent stock dividend, in the nature of a stock split, with the market price of an equal number of shares after the stock split. In the first instance, the court matched 100 of the 10,500 shares "sold"[29] by Enterprises on October 6, 1955 against a "purchase" by Enterprises of 100 shares of new Air-Way Common on October 16, 1955. The "sale" on October 6 was at a price of $19 per share, resulting in total proceeds of $1,900. The October 19 "purchase" of new Air-Way Common, which reflected the 2-for-1 split, was at a considerably lower price, $1,017. Thus, the "profit realized" according to the district court was $883.00. In the second instance the lower court, without any recognition of the intervening stock split, matched 100 of the shares of Air-Way Common that Lamb had sold over the American Stock Exchange on September 15, 1955 against a purchase by Lamb on October 6, 1966 of 100 shares of new Air-Way Common.[30]

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[28] Without revealing the basis for their computation counsel for Lamb and Enterprises state that the "profit realized" from matching the September sale of 300 shares against the purchase of a like number of shares in March totals only $1,616.04.

[29] The October 6, 1955 disposition of 10,500 shares of Air-Way Common by Enterprises to Industries would seem to be a Section 16(b) "sale." At that time Lamb no longer controlled 97 per cent of Industries. See note 26 *supra*.

[30] It should be noted that the district court had already matched the 300 shares sold on September 15, 1955 against 300 shares previously purchased. See text accompanying note 28 *supra*. This would seem to be contrary to well-established Section 16(b) procedures. *Gratz* v. *Claughton*, 187 F. 2d 46 (2 Cir.), *cert. denied*, 341 U. S. 920 (1951) "obviously no transaction can figure in more than one equation").

We agree with the Securities and Exchange Commission that when a purchase or sale that precedes a stock dividend (or stock split) is to be matched against a sale or a purchase made after the record date for the dividend distribution (or the split) there should be a proportionate adjustment in the price per share of the stock obtained or disposed of in the earlier transaction in order to determine the true measure of profit realized, if any, in the later transaction. Cf. *Kornfeld* v. *Eaton*, 217 F. Supp. 671 (SDNY 1963), *aff'd*, 327 F. 2d 263 (2 Cir. 1964).

Adopting this approach we must reverse both of the lower court's computations of "profit realized" here under consideration because of failure to take account of the 100 per cent stock dividend in the nature of a stock split. In the first instance the sales price of one old share of Air-Way Common was $19; the purchase price plus commissions of one new share was $10.17. Two new shares were the equivalent of one old share. Therefore, the cost of one new share should have been matched against one-half of the price of an old share, that is, $9.50. It is apparent that once this adjustment is made there is no profit, and no recovery, because the cost of one new share exceeded the adjusted sales price. Similarly in the second instance, although the unadjusted sales price exceeded the purchase price, thus leading the court to conclude that a recoverable profit had been realized, once the sales price is adjusted to reflect the split, all profit disappears.

D. *The Cash Dividends on Air-Way Common.*

Blau maintains that the 30¢ per share cash dividend paid by Air-Way on August 1, 1955, to holders of record of Air-Way Common on July 20, 1955 should have been included as part of the "profit realized" on the following transactions: the 10,500 shares of old Air-Way Common "purchased" on June 6, 1955, and sold on October 13, 1955;

the 6,500 shares of old Air-Way Common "purchased" on June 6, 1955, and the 6,500 shares of new Air-Way Common "sold" on October 13, 1955; and the 300 shares of old Air-Way Common "purchased" on June 6, 1955, and sold on September 15, 1955. Preliminarily we note that the cash dividends with respect to the first two transactions are not recoverable, because, as we previously have held, the acquisition by Enterprises on June 6, 1955 was not a Section 16(b) purchase and thus those paired transactions were not covered by Section 16(b). See note 22 *supra*. The claim for recovery of the cash dividend of 30¢ per share is, nevertheless, relevant to the transaction involving 300 shares of Air-Way Common. As to that issue we affirm the district court's conclusion that the cash dividend was, "too incidental and not 'so inextricably connected' with defendant's purchase-and-sale transactions to be included in the amount recoverable." 242 F. Supp. at 161. See *Adler* v. *Klawans*, 267 F. 2d 840 (2 Cir. 1959). Air-Way had paid regular quarterly dividends since June of 1954; the 30¢ per share dividend declared on June 30, 1955 was an increase of only 5¢ per share over these prior quarterly dividends. In view of this dividend payment history we cannot say that the lower court erred in concluding that the June 1955 dividend was not part of a scheme of short-swing speculation.

E. *Interest.*

We affirm the district court's discretionary disallowance of interest on the "profit realized" recoverable by Air-Way in this action; we are unable to say that the denial was "either so unfair or so inequitable as to require us to upset it." *Blau* v. *Lehman*, 368 U. S. 403, 414 (1962).

IV. *Summary.*

The district court decided, and Lamb and Enterprises do not appeal from that decision, that certain purchases and sales of Air-Way Common in 1956 by Enterprises resulted in a recoverable profit of $589. We affirm. We also hold, for reasons previously stated, that the purchase and sale of 300 shares of Air-Way Common on the American Stock Exchange in 1955 resulted in a recoverable profit of $1,666.02. Blau also asserts that an additional liability of $5,556.38 results from matching purchases by Enterprises of 1,600 shares on the American Stock Exchange between May 2 and September 8, 1955, for an aggregate price of $24,843.62, against the sale by Lamb of 1,600 shares on October 6, 1955, at $19 per share to Lamb Industries Inc.; the defendants do not contest this additional liability. Furthermore, we conclude, as did the district court, that the 30¢ per share cash dividend was not recoverable in connection with the 1955 transactions, including the pairing of the 300 shares of Air-Way Common mentioned above. We affirm the discretionary disallowance of interest. In all other respects the decision of the court below is reversed.

APPENDIX

Statutes.

Sections 16(a) and Section (b) of the Securities Exchange Act of 1934, 15 U.S.C.A., Sects. 78p(a) and 78p(b), provide as follows:

"(a) Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered pursuant to section 78 of this title, or who is a director or an officer of the issuer of such security, shall file, at the time of the registration of such security on a national securities exchange or by the effective date of a registration statement filed pursuant to section 78 (g) of this title, or within ten days after he becomes such beneficial owner, director, or officer, a statement with the Commission (and, if such security is registered on a national securities exchange, also with the exchange) of the amount of all equity securities of such issuer of which he is the beneficial owner, and within ten days after the close of each calendar month thereafter, if there has been a change in such ownership during such months, shall file with the Commission (and if such security is registered on a national securities exchange, shall also file with the exchange), a statement indicating his ownership at the close of the calendar month and such changes in his ownership as have occurred during such calendar month."

"(b) For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an

exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection."

Section 3(a)(13) of the Securities Exchange Act of 1934, 15 U.S.C.A., Sect. 78c(a)(13), provides as follows:

"The terms 'buy' and 'purchase' each include any contract to buy, purchase, or otherwise acquire."

Section 3(a)(14) of the Securities Exchange Act of 1934, 15 U.S.C.A., Sect. 78c(a)(14), provides as follows:

"The terms 'sale' and 'sell' each include any contract to sell or otherwise dispose of."

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

No. 720

ISADORE BLAU, a stockholder of AIR-WAY INDUSTRIES, INC., suing on behalf of himself and all other stockholders similarly situated and on behalf and in the right of Air-Way Industries, Inc.,

Petitioner,

vs.

EDWARD LAMB and EDWARD LAMB ENTERPRISES, INC.,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR RESPONDENTS IN OPPOSITION

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November 7, 1966.

INDEX

	PAGE
COUNTERSTATEMENT OF QUESTIONS PRESENTED	1
SUMMARY OF BASES FOR DENIAL OF PETITION	2
THE FACTS	2
(1) The Conversion Transaction	3
(2) The Transfer Between Corporate Pockets Transaction	5
ARGUMENT	
I. No Conflict of Decisions Exists	7
II. The Question of Liability With Respect to the Conversion Transaction Is of Limited Importance Because Such Transactions Have Now Been Exempted From Section 16(b) By Rule 16b-9	7
III. The Decision on the Transfer Between Corporate Pockets Transaction Is Limited to the Facts of This Case and Does Not Have Broad Significance	8
IV. The Decision Below as to Both Transactions Was Correct	9
CONCLUSION	10
APPENDIX	11

CITATIONS

Cases

PAGE

Basalt Rock Co. v. *Commissioner,* 180 F. 2d 281 (9th Cir. 1950), *cert. denied,* 339 U. S. 966 8

Beal v. *United States,* 182 F. 2d 565 (6th Cir. 1950), *cert. denied,* 340 U. S. 852 8

Blau v. *Mission Corp.,* 212 F. 2d 77 (2d Cir. 1954), *cert. denied,* 347 U. S. 1016 10

Heli-Coil Corp. v. *Webster,* 352 F. 2d 156 (3d Cir. 1965) 7, 9

United States v. *Abrams,* 197 F. 2d 803 (6th Cir. 1952), *cert. denied,* 344 U. S. 855 8

United States v. *Community Servs., Inc.,* 189 F. 2d 421 (4th Cir. 1951), *cert. denied,* 342 U. S. 932 ... 8

Statutes and Regulations

Section 16(b), Securities Exchange Act of 1934, 48 Stat. 896, 15 U. S. C. 78 p(b) (1964) ..... *passim*

31 Fed. Reg. 3391 (1966), amending 17 C. F. R. 240. 16b-9 (1964) 8, 11

Miscellaneous

Stern, *Denial of Certiorari Despite a Conflict,* 66 Harv. L. Rev. 465 (1953) 8

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BRIEF FOR RESPONDENTS IN OPPOSITION

COUNTERSTATEMENT OF QUESTIONS PRESENTED

The questions presented by the Petition, although stated by the Petitioner in the form of five questions, are in substance only two:

(1) Is there any liability under Section 16(b) of the Securities Exchange Act of 1934 for a "profit realized" by an insider by reason of the acquisition of a convertible security and the conversion thereof within six months where the convertible security and the security into which it is converted are economic equivalents in terms of their opportunity for appreciation in market value?

(2) Does the acquisition of securities of an issuer by an insider corporation constitute a "purchase" of the securities within the meaning of Section 16(b) of the Securities Exchange Act of 1934 where the owners of 100% of the acquiring insider corporation own 97% of the transferring corporation?

SUMMARY OF BASES FOR DENIAL OF PETITION

(1) With respect to the first question, no decision of a United States Court of Appeals conflicts with the decision in this case. In a similar fact situation, the Court of Appeals for the Third Circuit relied upon a different rationale in coming to the identical conclusion that no liability exists. Moreover, the decision below is of limited importance because the Securities and Exchange Commission has now adopted a rule exempting from Section 16(b) all similar transactions after the effective date of the rule.

(2) With respect to the second question, no decison of a Court of Appeals conflicts with the decision in this case, and Petitioner does not assert that a conflict exists. The decision is limited to the facts of this case and does not have any broad significance.

(3) The decision below as to both transactions was correct.

THE FACTS

Petitioner seeks review of the decision of the Court of Appeals for the Second Circuit (a copy of which is attached to the Petition) to the extent that it held that two transactions (referred to herein as the "Conversion Transaction" and the "Transfer Between Corporate Pockets

Transaction") did not result in any liability under Section 16(b) of the Securities Exchange Act of 1934.[1]

(1) The Conversion Transaction.

In June 1955 the decision was made to combine Air-Way Industries, Inc. ("Air-Way") with Lamb Industries, Inc. ("Lamb Industries"). At the time, Edward Lamb ("Lamb"), members of his family, and corporations controlled by them owned at least 35½% of the outstanding shares of Common Stock of Air-Way and had five of their nominees among the seven directors of Air-Way (R. A7, 9).[2] Lamb, members of his family, and corporations controlled by them owned 97% of Lamb Industries (R. A7).

On June 9, 1955, the Board of Directors of Air-Way approved an offer to the shareholders of Lamb Industries to exchange one share of 5% Cumulative Convertible Preferred Stock of Air-Way for each five shares of Common Stock of Lamb Industries (R. A10). The Air-Way Preferred was convertible at any time into Air-Way Common at a rate of 3½ shares of Air-Way Common for each share of Air-Way Preferred. In the event of any stock dividend or split-up by reclassification or other method of the shares of Air-Way Common, the number of shares of Air-Way Common into which the shares of Air-Way Preferred were convertible would be appropriately adjusted (R. A49-52).

In accordance with Air-Way's offer, Lamb and Edward Lamb Enterprises, Inc. ("Lamb Enterprises"), a corpora-

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[1]The decision below reversed the judgment of the District Court on all questions not conceded by Respondents. Petitioner does not seek review with respect to transactions other than the two herein described.

[2]References are to pages of the Record certified to this Court by the Clerk of the United States Court of Appeals for the Second Circuit.

tion 100% owned by Lamb, members of his family, and corporations controlled by them, exchanged an aggregate of 199,245 shares of Lamb Industries Common for an aggregate of 39,849 shares of Air-Way Preferred during the period of July through September 1955 (R. A11-12). On September 13, 14, and 15, 1955, Lamb and Lamb Enterprises converted those 39,849 shares of Air-Way Preferred into Air-Way Common (R. A12).

Petitioner asserted, and Respondents conceded, that the acquisition of the Air-Way Preferred constituted a "purchase" within the meaning of Section 16(b). Petitioner asserted that the conversion of the Air-Way Preferred constituted a "sale" within the meaning of Section 16(b) and that a "profit" had been "realized" by Respondents from those transactions equivalent to the difference in the value of the Lamb Industries Common given in exchange for the Air-Way Preferred and the value of the Air-Way Common issued upon conversion of the Air-Way Preferred. The District Court adopted Petitioner's theory and held Respondents liable for a "profit realized" of $1,138,782.31 (R. A41-42).

On appeal, Respondents contended that the conversion did not give rise to any liability, on the alternative grounds either that there was no "sale" or that there was no "profit realized". Because the Air-Way Preferred and Air-Way Common were economic equivalents and Respondents' investment was subject to at least as great a market risk following conversion as prior to conversion,[3] there

[3]In the context of Section 16(b), securities are "economic equivalents" when their market values fluctuate on an equivalent basis. The market value of a convertible security, such as the Air-Way Preferred, will fluctuate in direct relationship with the market value of the security into which it is convertible, except that the market value of the convertible security will not fall below the value of that security without the conversion feature. Thus the opportunities for appreciation are the same regardless of which security is held; the risk of loss is somewhat greater after conversion.

was no opportunity to profit from use of inside information and hence no basis for construing the definition of "sale" in Section 16(b) to cover the conversion transaction; and, in any event, since Respondents' investment position was identical (except for a somewhat greater downside risk) before and after conversion, no "profit" was "realized". The Securities and Exchange Commission in its *amicus* brief in the court below supported Respondents' alternative position that there was no "profit realized".

The Court of Appeals reversed the decision of the District Court on the ground that the conversion of the Air-Way Preferred did not constitute a "sale" within the meaning of Section 16(b):

> "[W]e hold that the economic equivalence of the Air-Way Preferred and the Air-Way Common and the unchanged investment position of Lamb and Enterprises combined to insure that this conversion afforded the insiders no opportunity to realize a gain by speculative trading in Air-Way Preferred. For this reason, we hold that the conversion was not a Section 16(b) sale of the Preferred." (R. A89)

The Court of Appeals explicitly limited its decision to the type of transactions here involved—a purchase of a convertible security and a conversion of that security (R. A92-93).

(2) The Transfer Between Corporate Pockets Transaction.

On June 6, 1955, Lamb Industries transferred to Lamb Enterprises 68,100 shares of Air-Way Common as part of an exchange of assets (R. A18-19). The transfer was treated by the District Court as a "purchase" by Lamb Enterprises of the 68,100 shares, even though the Lamb interests owned

100% of Lamb Enterprises and 97% of Lamb Industries. The District Court held Respondents liable for profits totaling $156,229.02 based in part on that "purchase" (R. A41-42).

Respondents appealed from that determination on the ground, among others, that the transfer from Lamb Industries to Lamb Enterprises was not a "purchase" by Lamb Enterprises within the meaning of Section 16(b). The Securities and Exchange Commission in its *amicus* brief supported Respondents' position. The Court of Appeals reversed and held that the transaction was not a "purchase" by Lamb Enterprises:

> "By virtue of Lamb's pervasive control over Industries and Enterprises, there was at most a token change in the insider's investment position when Air-Way Common was transferred from Industries to Enterprises; Lamb indirectly owned this stock both before and after its transfer. Thus Lamb did not place himself where he could make any more advantageous use of inside information for speculative purposes than he could have before the transfer. Nor did the decision to transfer the Air-Way Common alter the nature of his investment, increase or decrease the amount invested, or alter in any way the risks involved." (R. A97)
>
> "...
>
> "The transfer to Enterprises of the Air-Way Common in no way increased Lamb's power to make use of inside information, and for this reason that transfer was not a Section 16(b) 'purchase' of the Common." (R. A98).

ARGUMENT

I. NO CONFLICT OF DECISIONS EXISTS.

There is no Court of Appeals decision conflicting with the result reached by the Court of Appeals for the Second Circuit in this case. Petitioner does not even assert a conflict with respect to the Transfer Between Corporate Pockets Transaction. Although Petitioner asserts that the decision in *Heli-Coil Corp.* v. *Webster,* 352 F. 2d 156 (3d Cir. 1965) "conflicts directly with the decision [as to the Conversion Transaction] rendered below . . ." (Petition, page 15), no such conflict exists.

Heli-Coil involved two separate alleged "purchases" and "sales": (i) the acquisition of convertible debentures and the conversion of the debentures into common stock within six months and (ii) the acquisition of common stock upon conversion of the debentures and the sale of the common stock for cash within six months. The first pair of transactions in *Heli-Coil* presented the same question raised by the Conversion Transaction in this case. The Court of Appeals for the Third Circuit held that no liability existed with respect to the acquisition of the debentures and their conversion within six months. A majority of the Court of Appeals for the Third Circuit held that there was no liability on the ground that there was no "profit realized" (352 F. 2d at 167-68), while Judges Hastie and Kalodner reached the same result on the ground that the conversion was not a "sale" (352 F. 2d at 171-74). The second pair of transactions in *Heli-Coil* does not have any counterpart in this case.

II. THE QUESTION OF LIABILITY WITH RESPECT TO THE CONVERSION TRANSACTION IS OF LIMITED IMPORTANCE BECAUSE SUCH TRANSACTIONS HAVE NOW BEEN EXEMPTED FROM SECTION 16(b) BY RULE 16b-9.

The decision of the Court of Appeals with respect to the Conversion Transaction is of limited importance because

the Securities and Exchange Commission has now specifically exempted from the scope of Section 16(b) all such transactions. Under the last sentence of Section 16(b), the Securities and Exchange Commission has the power to exempt transactions "not comprehended within the purpose of" Section 16(b). Pursuant to that authority, the Commission adopted Rule 16b-9, 31 Fed. Reg. 3391 (1966), amending 17 C. F. R. 240. 16b-9 (1964), a copy of which is annexed as an Appendix. That Rule, effective February 17, 1966, exempts (with certain exceptions not relevant to the Conversion Transaction) any acquisition or disposition of an equity security upon the conversion of an equity security into another equity security of the same issuer.

This Court has frequently refused to grant a writ of certiorari where because of a change in the applicable law the question involved was no longer significant. *United States* v. *Abrams,* 197 F. 2d 803 (6th Cir. 1952), *cert. denied,* 344 U. S. 855; *United States* v. *Community Servs., Inc.,* 189 F. 2d 421 (4th Cir. 1951), *cert. denied,* 342 U. S. 932; *Basalt Rock Co.* v. *Commissioner,* 180 F. 2d 281 (9th Cir. 1950), *cert. denied,* 339 U. S. 966; *Beal* v. *United States,* 182 F. 2d 565 (6th Cir. 1950), *cert. denied,* 340 U. S. 852; see Stern, *Denial of Certiorari Despite a Conflict,* 66 Harv. L. Rev. 465 (1953) (describing the above cases). Those cases all involved clear conflicts among circuits and several involved questions applicable to a large number of pending claims arising prior to the change of law; neither factor is present in this case.

III. THE DECISION ON THE TRANSFER BETWEEN CORPORATE POCKETS TRANSACTION IS LIMITED TO THE FACTS OF THIS CASE AND DOES NOT HAVE BROAD SIGNIFICANCE.

The decision that the transfer of shares between Lamb Industries (97% owned by Lamb interests) and Lamb Enterprises (100% owned by Lamb interests) did not con-

stitute a "purchase" under Section 16(b) is limited to the particular fact situation. The Court of Appeals explicitly declined to formulate a general rule (R. A98). Therefore, there is no "special and important reason" for this Court to review that decision.

IV. THE DECISION BELOW AS TO BOTH TRANSACTIONS WAS CORRECT.

The decision was correct. In accordance with clear Congressional intent, and contrary to Petitioner's contention (Petition, page 13), the decision below does not require proof in each case that the insider obtained or misused confidential information in order to establish liability under Section 16(b). The Court of Appeals held that in determining whether a conversion is a "sale" within the meaning of Section 16(b) "the question is whether the conversion facilitates short-term speculative trading in the issuer's preferred." (R. A93) It concluded that, because the conversion did not alter the insider's investment position, the purchase and conversion within six months could not be used by an insider to facilitate short-term speculation. The Court of Appeals held therefore that the conversion was not a "sale" within the meaning of Section 16(b). In a similar situation, the Third Circuit in *Heli-Coil Corp. v. Webster, supra,* also held that there was no liability, but on the basis that there was no "profit realized". The Securities and Exchange Commission in its *amicus* brief supported the latter rationale. Under either rationale, the result in so far as Respondents are concerned is the same—there is no liability under Section 16(b).[4]

The Court of Appeals' holding that the transfer of an equity security from a company 97% controlled by Respondents to another company 100% controlled by Respondents

[4]Petitioner incorrectly states (Petition, page 12 and footnote 6) that the Congressional history shows an intention to include conversions as "sales". None of the authorities cited in footnote 6 of the Petition supports that statement.

was not a "purchase" is in accord with the only other decision in point, *Blau* v. *Mission Corp.*, 212 F. 2d 77 (2d Cir. 1954), *cert. denied*, 347 U. S. 1016, and with the position taken by the Securities and Exchange Commission in its *amicus* brief.

CONCLUSION

The Petition seeks review of a decision that (i) is not in conflict with a decision of the Court of Appeals of any other circuit, (ii) in so far as it relates to the Conversion Transaction is of very limited significance because of the adoption by the Securities and Exchange Commission of Rule 16b-9, and (iii) in so far as it relates to the Transfer Between Corporate Pockets Transaction is of limited significance because it is applicable only to the facts of this case. Furthermore, the decision below on both transactions is clearly correct. Accordingly, the petition for a writ of certiorari should be denied.

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November 7, 1966.

APPENDIX

Rule 16b-9 Under the Securities Exchange Act of 1934
(Effective February 17, 1966)

Exemption from section 16(b) of transactions involving the conversion of equity securities.

(a) Any acquisition or disposition of an equity security involved in the conversion of an equity security which, by its terms or pursuant to the terms of the corporate charter or other governing instruments, is convertible immediately or after a stated period of time into another equity security of the same issuer, shall be exempt from the operation of section 16(b) of the Act: *Provided, however,* That this section shall not apply to the extent that there shall have been either (1) a purchase of any equity security of the class convertible (including any acquisition of or change in a conversion privilege) and a sale of any equity security of the class issuable upon conversion, or (2) a sale of any equity security of the class convertible and any purchase of any equity security issuable upon conversion (otherwise than in a transaction involved in such conversion or in a transaction exempted by any other rule under section 16(b)) within a period of less than 6 months which includes the date of conversion.

(b) For the purpose of this section, an equity security shall not be deemed to be acquired or disposed of upon conversion of an equity security if the terms of the equity security converted require the payment or entail the receipt, in connection with such conversion, of cash or other property (other than equity securities involved in the conversion) equal in value at the time of conversion to more than 15 percent of the value of the equity security issued upon conversion.

(c) For the purpose of this section, an equity security shall be deemed convertible if it is convertible at the option of the holder or of some other person or by operation of the terms of the security or the governing instruments.

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ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

REPLY BRIEF IN SUPPORT OF PETITION FOR CERTIORARI

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TABLE OF CONTENTS

	PAGE
I—The opinion by Court below is of grave and continuing concern to the general investors and management of public corporations and its broad implications are not limited solely to the particular facts of this case	1
Conclusion	6

TABLE OF CASES

Blau v. Lehman, 368 U. S. 403	5
Gratz v. Claughton (C. A. 2), 187 F. 2d 46	3
Greene v. Dietz (C. A. 2), 247 F. 2d 689	6
Heli-Coil Corp. v. Webster (C. A. 3), 352 F. 2d 156	3, 5
Petteys v. Blau (C. A. 8), decided October 19, 1966, and not yet reported. For full text of opinions see pp. 15-35 of Appendix to pending Petition for Certiorari in Blau v. Petteys, No. 755, filed in Supreme Court of the United States	4, 5, 6
Smolowe v. Delendo Corp. (C. A. 2), 136 F. 2d 231	5
Western Auto Supply Company v. Gamble-Skogmo, Inc. (C. A. 8), 348 F. 2d 736	3

STATUTES AND RULES

PAGE

Securities Exchange Act of 1934, as amended in 1964:

Sects. 12(g), 16(a), 16(b), 15 U.S.C.A., Sects. 78L(g), 78p(a), 78p(b) 5

Securities & Exchange Commission Rules:

Rule 16b-9, 31 Fed. Reg. 3391, 17 C.F.R., Sect. 240.16b-9, as amended 4

OTHER AUTHORITIES

Stock Exchange Practices, Hearings before the Senate Committee on Banking and Currency, 73d Cong., 1st Sess., pt. 15 (1934) p. 6558 3

IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

No. 720

ISADORE BLAU, a stockholder of Air-Way Industries, Inc., suing on behalf of himself and all other stockholders similarly situated and on behalf and in the right of Air-Way Industries, Inc.,

Petitioner,

against

EDWARD LAMB and EDWARD LAMB ENTERPRISES, INC.,

Respondents.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

REPLY BRIEF IN SUPPORT OF PETITION FOR CERTIORARI

I

The opinion by the Court below is of grave and continuing concern to the general investors and management of public corporations and its broad implications are not limited solely to the particular facts of this case.

The opinion of the Court below is predicated upon the rationale that every short-swing transaction must be closely examined on a case-by-case basis to determine whether it

is susceptible to the statutory abuse, and that the provisions of Section 16(b) of the Act will be applied to the transaction only after such a *subjective* "initial inquiry" has convinced the Court of that fact.

If permitted to stand, the opinion of the Court below would have serious implications far beyond the immediate issues here involved. For, not only would such a *subjective* test for the statutory application be required in the case of conversion transactions alone, but it would necessarily have to be applied as well in cases where the insider exercises an option to acquire his issuer's stock, in cases where he exchanges his issuer's shares for the securities of another corporation, in cases where he receives his issuer's shares in exchange for property, and in numerous similar situations. In fact, it is entirely conceivable that an insider might urge in the future that his ordinary *cash* purchases and sales of his issuer's securities within less than six months are not subject to the provisions of Section 16(b) of the Act because such transactions were not susceptible to the statutory abuse.

Wholly apart from the fact that such a *subjective* approach to the statutory application would place an unconscionable burden upon the issuer, or a stockholder suing on its behalf, to prove that the insider's transaction was susceptible to the statutory abuse (a burden which Congress never intended to impose), the execution of Section 16(b) would be bogged down by uncertainty and doubt because neither the issuer nor the insider would ever know with certainty whether the latter's short-swing transaction were susceptible to such statutory abuse or could be proven.

By expressly *eliminating* all considerations with respect to an insider's *subjective* purpose in effecting his short-swing transaction, Congress clearly evinced its intention that the provisions of Section 16(b) of the Act should be applied *automatically* and *without prior inquiry* as to the fairness of the particular transaction or its susceptibility

to the statutory evil, "even though it may cover instances where it (the evil) is *not* present."[1]

Such purposeful simplicity in the statutory application, and the "sure and speedy" remedy envisaged thereby, were intended to operate as one of its greatest deterrents in discouraging the insider from short-term speculation in his issuer's securities and his possible misuse of inside information in connection therewith. In order not to envelop the execution of the statute in a morass of factual and legal issues which would tend to vitiate the simplicity of its operation and destroy its effectiveness, the statutory application demanded "the necessity of having a general rule" to be applied *alike* in *all* cases.[2]

The respondents erroneously argue in their brief (pp. 7-8) that the decision by the Court below with respect to their conversion transactions allegedly "is of limited importance" because of the recently adopted Rule 16b-9 under which the Commission has purported to exempt from the statutory operation certain conversion transactions *meet-*

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[1] *Gratz* v. *Claughton* (C. A. 2), 187 F. 2d 46, at page 50.

[2] "You have to have a general rule. In particular transactions it might work a hardship, but those transactions that are a hardship represent the sacrifice to the necessity of having a general rule." *Stock Exchange Practices, Hearings before the Senate Committee on Banking and Currency*, 73d Cong., 1st Sess., pt. 15 (1934), p. 6558 (testimony of Corcoran).

In *Heli-Coil Corp.* v. *Webster* (C. A. 3), 352 F. 2d 156, the Court cited the above passage with approval, stating (at pp. 165-166) that the language of Section 16(b) indicates that it was the Congressional purpose "to lay down a hard and fast rule" for the statutory application with respect to all transactions alike and "that Section 16(b) does set up a 'rule of thumb' and was intended by Congress to do precisely that."

In *Western Auto Supply Company* v. *Gamble-Skogmo, Inc.* (C. A. 8), 348 F. 2d 736, the Court similarly expressed its approval for such a "general rule", stating (at p. 744): Section 16(b) must be construed so as to not dilute its vitality. We cannot have one rule for insiders with good intentions and another for those who would flagrantly abuse their trust. The burdens of the Act must fall on all violations with equal weight."

ing the specific conditions set forth in that rule, "as not comprehended within the purpose of" Section 16(b).[3]

We have heretofore shown, however, that the implications of the opinion below go far beyond the immediate issue with respect to the particular conversion transactions here involved, and that its rationale could be equally applicable to many other, and perhaps *all* other, transactions involving possible violations of Section 16(b).

Moreover, Rule 16b-9 does *not* purport to exempt *every* conversion transaction from the statutory operation. The provisions of the Rule, by its express language, only purport to exempt those *particular* conversion transactions which meet the *specific conditions* set forth therein. Furthermore, in view of the express language and legislative history of Section 16(b) clearly indicating the Congressional purpose *to include* conversion transactions *within* the statutory operation, the validity of the Rule itself is extremely doubtful on the ground that the Commission exceeded its authority in adopting it.[4]

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[3] The text of Rule 16b-9, 31 Fed. Reg. 3391 (1966), 17 C.F.R. Sect. 240.16b-9, as amended, is set forth in Respondents' Appendix to its brief at page 11. The Rule became effective February 17, 1966 and was not intended to be applied retroactively.

[4] See *Petteys* v. *Blau* (C. A. 8), decided October 19, 1966, not yet reported. A Petition for a writ of certiorari in that case is presently pending before the Supreme Court of the United States (*Blau* v. *Petteys*, No. 755). The full text of the majority and dissenting opinions is set forth at pp. 15-35 of the Appendix to the Petition on file with this Court in that case. The majority opinion, adhering to the rationale of the Second Circuit in *Blau* v. *Lamb*, held that the insiders' conversions of Preferred into common stock were not Section 16(b) "purchases" of the common shares. Although the majority stated (at p. 32) that "our decision is not based on the S.E.C. amended Rule 16b-9 dealing with conversions", Judge Blackmun, in his dissenting opinion, made the following observation (at p. 34) with respect to the Commission's power to adopt such Rule:

"* * * I am not entirely sure that Congress, by the subsection's final sentence (of Section 16b), meant to give the Commission

(Footnote continued on following page)

We parenthetically note that for a period of more than thirty years following the enactment of Section 16(b) the Commission had traditionally supported the view, based upon its interpretation of the legislative history and language of the statute, that an insider's voluntary conversion of his issuer's security *was indeed comprehended within the purpose of that statute.*[5] Significantly, although the recent amendments to the Securities Exchange Act of 1934 expressly *broadened* the applicability of Section 16(b) by including certain *unlisted* public corporations within its scope, neither such amended statutory language nor its legislative history indicates any Congressional intention to exempt a voluntary conversion transaction from the operation of Section 16(b).[6] While it is true that the Commission was granted the authority to exempt a transaction from the operation of Section 16(b) if it found that the transaction was "not comprehended within the purpose of" that statute, such "actually limited authority" requires "that its regulations be consistent with the expressed purpose of the statute."[7] Moreover, the Commis-

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(Footnote continued from preceding page)

the power so to legislate at will by abruptly changing the reach of the statute which it had regarded otherwise for over a generation, or that, if it did, such delegated authority is not vulnerable to attack, or that the announced new rule is consistent with the statute anyway. * * *."

[5] The Commission supported such view as *amicus curiae* in this very case in the Court below. It also supported such view as *amicus curiae* in *Heli Coil Corp.* v. *Webster* (C. A. 3, 1965), *supra*, and in *Petteys* v. *Blau* (C. A. 8, 1966), *supra*.

[6] Sects. 12(g), 16(a) and 16(b) of the Securities Exchange Act of 1934, as amended in 1964; 15 U.S.C.A., Sects. 78L(g), 78p(a) and 78p(b). In *Blau* v. *Lehman*, 368 U. S. 403, this Court stated (at p. 413): "Congress can and might amend Sect. 16(b) if the Commission would present to it the policy arguments it has to us, but we think that Congress is the proper agency to change an interpretation of the Act unbroken since its passage, if the change is to be made."

[7] *Smolowe* v. *Delendo Corp.* (C. A. 2), 136 F. 2d 231, 240.

sion's exercise of its authority in adopting such an exemptive Rule is always subject to judicial scrutiny "in order to ascertain whether the Rule was a proper exercise of the authority delegated to the Commission under the Act.'"[8]

The conflicting views and dissenting opinions between and within the various Circuit Courts of Appeals, as to whether the application of Section 16(b) of the Act requires an "objective" or a "subjective" test, has recently led Judge Blackmun to make the following remark in his dissenting opinion in *Petteys* v. *Blau* (C. A. 8, 1966), *supra*:[9]

> "Perhaps the Supreme Court one day soon will tell us how these somewhat conflicting approaches to Section 16(b) by the Courts of Appeals are to be resolved. * * *."

CONCLUSION

For the reasons stated above and in the petition for a Writ of Certiorari, this petition for a Writ of Certiorari should be granted.

Respectfully submitted,

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[8] *Greene* v. *Dietz* (C. A. 2), 247 F. 2d 689, 692.

[9] See p. 35 of Appendix in petition for writ of certiorari (*Blau* v. *Petteys*, No. 755.)